Concurrent Session: Deep Dive #2: Implementing the Revenue Recognition Standard

Friday, March 24th
11:00am – 12:15pm
La Quinta Resort & Club, La Quinta, California

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A Roadmap to Applying the New Revenue Recognition Standard

2016

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Preface

September 2016

To the clients, friends, and people of Deloitte:

We are pleased to present *A Roadmap to Applying the New Revenue Recognition Standard*, a comprehensive overhaul of our previous version, *Revenue From Contracts With Customers: A Roadmap to Applying the Guidance in ASU 2014-09*.

On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. Despite issuing final guidance after nearly 12 years of development, the past two years of the implementation effort have been marked by continuing discussion and debate. As a result, the boards amended some aspects of their "final" standard.

For those of you who have closely followed these developments, we hope that this Roadmap will serve as a one-stop guide to the current state (as of September 2016) of the final guidance. For those of you who have not been following the standard since 2002 (or even 2014), not to worry; this Roadmap should bring you up to speed. This publication has been developed to meet the needs of both types of readers. That is, it may function as a quick resource guide for those who have a specific question and are looking for a clear answer, or it may serve as an all-encompassing guide for those who are still building up their knowledge base to lead or work through an implementation.

Our mind-set when creating this Roadmap was to provide a document that will be dynamic throughout the remaining implementation period; we expect that the end of the road is not included in this version. We will continue to update our discussion of topics, enhance our explanations and examples, and report on any other recent developments in the years to come. We hope that you find this Roadmap — and its future updates — to be a constant resource to you on your implementation journey.

Nonetheless, our number one recommendation is: **get started!** From our experience, the implementation journey is a marathon involving extensive preparation and training — not a quick sprint. Because revenue permeates all areas of any company, this journey requires the collaborative efforts of multiple departments within a company (IT, Sales, Tax, Investor Relations, Human Resources, and others), in addition to the financial reporting organization. A successful implementation requires early and collective discussions between the company's departments, its auditor, and its advisers.

So remain focused on your implementation efforts (or get started right away), stay tuned for future developments and amendments, and engage your auditors and advisers in regular discussions. January 2018 (the mandatory effective date for calendar-year-end public companies) is only 15 months away.

We look forward to assisting you on this journey and hope that you find this Roadmap integral to your success. If you have any questions or suggestions for improvement, please do not hesitate to reach out to a Deloitte professional.

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Kristin Bauer and Eric Knachel supervised the overall preparation of this Roadmap and extend their deepest appreciation to the core development team — specifically, Chris Chiriatti, Chris Cryderman, Lauren Hegg, Elise Lambert, Taylor Paul, and PJ Theisen.

They would also like to acknowledge the members of our Production group for their contributions — especially Michael Lorenzo, the Production group leader; David Eisenberg, who continues to make “accounting-speak” understandable; Geri Driscoll, Jeanine Pagliaro, and Sandy Zapata, who checked and double-checked our work; and Teri Asarito, who designed the Roadmap’s layout and converted doodles and diagrams into professional images. They also wish to thank Deloitte’s U.S. Accounting Services and Auditing Services groups, particularly Mark Crowley, Joe DiLeo, Rachel Grandovic, Amy Groves, Denise Lucas, Lisa Mitrovich, Bob Uhl, Andrew Warren, and Andy Winters.

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Sincerely,

Deloitte & Touche LLP

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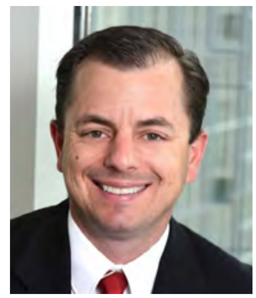

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Background

The goals of the FASB and IASB for the revenue recognition project were to improve and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues." The FASB and IASB believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

Revenue Project — Timeline

1999 (Dec)	SAB 101 issued
2000 +	Various EITF activity related to revenue recognition
2002 (May)	Revenue recognition project added to FASB's agenda
2008 (Dec)	FASB/IASB discussion paper issued
2010 (June)	Exposure draft (ED) on revenue recognition issued
2011 (Nov)	Revised ED issued
2014 (May)	Final standard on revenue recognition issued (ASU 2014-09 and IFRS 15)
2014 (June)	TRG established by the FASB and IASB
2014–2015	Five joint TRG meetings (see Appendixes D and E)
2015 (Aug)	ASU 2015-14 on change in effective date
2015 (Nov)	Sixth joint TRG meeting
2016 (Mar)	ASU 2016-08 on principal-versus-agent considerations issued
2016 (Apr)	Seventh TRG meeting (FASB only)
2016 (Apr)	ASU 2016-10 on identifying performance obligations and licensing
2016 (Apr)	Final standard on clarifications to IFRS 15
2016 (May)	ASU 2016-12 on narrow-scope improvements and practical expedients
2016 (May)	Proposed ASU on technical corrections
2016 (Nov)	**Eighth TRG meeting (FASB only)**
2017	**U.S. GAAP — early adoption election year**
2018	**Effective date of final standard (2019 nonpublic)**[1]

[1] For public entities, the new revenue standard is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. As a result, calendar-year-end companies are required to apply the new revenue standard in 2018. See Chapter 15 for further discussion of effective date and transition.

The boards' 2008 discussion paper on revenue recognition represented a significant milestone in the project. The project picked up momentum with the issuance of the June 2010 ED, for which the boards received nearly 1,000 comment letters. Then, in November 2011, the boards issued their revised ED after conducting extensive outreach and redeliberating almost every aspect of the original proposal. After further outreach and deliberations, the boards modified the proposal and issued the final standard in May 2014.

In addition, the boards created a joint TRG in June 2014 to research standard-related implementation issues and help the boards resolve questions that could give rise to diversity in practice. Throughout the remainder of 2014 and 2015, TRG members met and discussed topics that preparers, auditors, and industries had elevated to the TRG's attention. With the help of input from the TRG, the boards have issued additional revenue guidance and are in the process of finalizing further guidance or interpretations before the new revenue standard's effective date in 2018, which reflects the one-year deferral of the standard (see Chapter 19 for more information).

On January 21, 2016, the IASB issued an announcement that it has completed its decision-making process related to clarifying the new revenue standard and that it does not plan to schedule any additional TRG meetings for IFRS constituents. However, the FASB will continue to address implementation issues. One FASB-only TRG meeting was held in April 2016 and another such meeting is scheduled for November 2016.

Chapter 1 — Overview

On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09 by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

The goals of the revenue recognition project are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues."[1] The boards believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

1.1 Key Provisions of the ASU

The revenue model's core principle and application can be depicted as follows:

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

When?	The entity satisfies a performance obligation by transferring a good or service to the customer.
How much?	Amount to which the entity expects to be entitled (i.e., transaction price) allocated to the distinct goods or services.

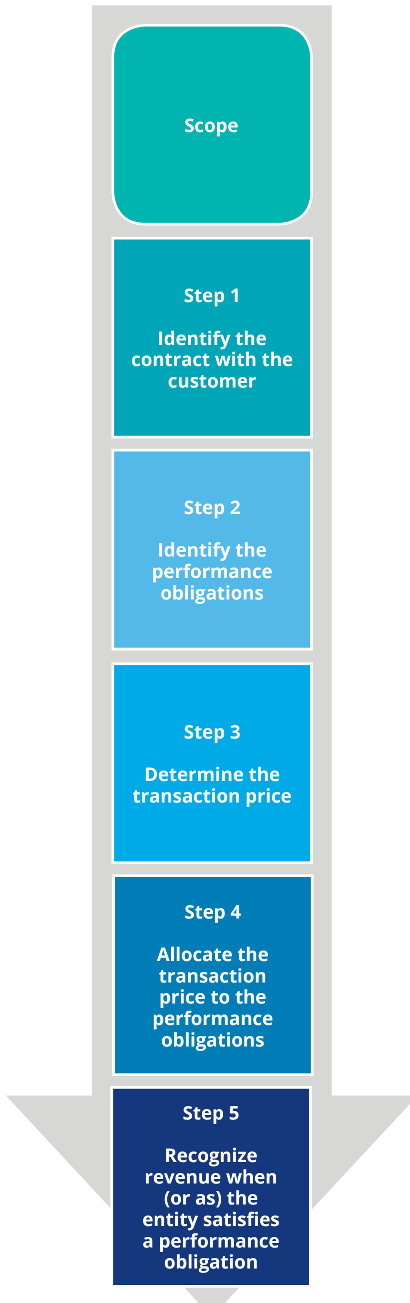
The core principle was established by the FASB and IASB and is the underpinning of the entire revenue framework. In this principle, the boards identified and answered the two most fundamental questions concerning revenue:

- When?
  - That is, when may an entity recognize revenue?
  - *Answer* — When the entity satisfies its obligations under a contract by transferring goods or services to its customer. That is, when the entity *performs*, it should recognize revenue.
- How much?
  - That is, how much revenue may an entity recognize?

[1] Quoted from ASU 2014-09.

- *Answer* — The amount to which the entity expects to be entitled to under the contract (i.e., an expected amount, so estimates may be required). The boards intentionally used the wording “be entitled” rather than “receive” or “collect” to distinguish collectibility risk from other uncertainties that may occur under the contract (see Chapters 3 and 6 for further discussion).

The core principle is supported by five steps (following a scope decision) in the new revenue framework, which are outlined in the following chart:



1.2 Scope (Chapter 3 of the Roadmap)

The ASU applies to all **contracts** with **customers** as defined in the new revenue standard (see Chapter 2 for definitions of terms included in the standard's glossary) except those that are within the scope of other topics in the *FASB Accounting Standards Codification*. The ASU does not apply to contracts within the scope of ASC 840 and ASC 842 (leases) and ASC 944 (insurance); contractual rights or obligations within the scope of ASC 310, ASC 320, ASC 321, ASC 323, ASC 325, ASC 405, ASC 470, ASC 815, ASC 825, and ASC 860 (primarily various types of financial instruments); contracts within the scope of ASC 460 (guarantees other than product or service warranties); and nonmonetary exchanges whose purpose is to facilitate a sale to another party (ASC 845).

Scope

Certain of the ASU's provisions also apply to transfers of nonfinancial assets, including in-substance nonfinancial assets that are not an output of an entity's ordinary activities (e.g., sales of (1) property, plant, and equipment; (2) real estate; or (3) intangible assets). Such provisions include guidance on recognition (including determining the existence of a contract and control principles) and measurement (existing accounting guidance applicable to these transfers (e.g., ASC 360-20) has been amended or superseded). See Chapter 17.

1.3 Step 1: Identify the Contract With the Customer (Chapter 4 of the Roadmap)

Step 1 requires an entity to **identify the contract** with the customer. A contract does not have to be written to meet the criteria for revenue recognition; however, it does need to create enforceable rights and obligations.

Step 1

Identify the contract with the customer

A contract can be written, verbal, or implied; however, the ASU applies to a contract only if all of the following criteria are met:

- "The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations."
- "The entity can identify each party's rights regarding the goods or services to be transferred."
- "The entity can identify the payment terms for the goods or services to be transferred."
- "The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)."
- "It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer."

Stakeholders should be aware that under U.S. GAAP, the "probable" threshold for collectibility as used in the criterion above for identifying the contract with the customer is defined differently from how it is defined under IFRSs. In U.S. GAAP, ASC 450-20 (formerly FAS 5) states that the term "probable" refers to a "future event or events [that] are likely to occur." In IFRSs, "probable" means "more likely than not." Because "more likely than not" under U.S. GAAP is a lower threshold than "probable," an entity may encounter differences between U.S. GAAP and IFRSs in determining whether a contract exists. For more discussion on differences between U.S. GAAP and IFRSs, refer to Appendix A.

If a contract does not meet these criteria at contract inception, an entity must continue to reassess the criteria to determine whether they are subsequently met. If the above criteria are not met in a contract with a customer, the entity is precluded from recognizing revenue under the contract until the consideration received is nonrefundable and one or more of the following events have occurred:

- All of the performance obligations in the contract have been satisfied, and substantially all of the promised consideration has been received.
- The contract has been terminated or canceled.
- The entity (1) has transferred control of the goods or services to which the consideration that has been received is related, (2) has stopped transferring goods or services, and (3) has no obligation to transfer additional goods or services.

If none of the events above have occurred, any consideration received would be recognized as a liability.

1.4 Step 2: Identify the Performance Obligations in the Contract (Chapter 5 of the Roadmap)

Step 2 requires an entity to **identify the distinct goods or services** promised in the contract. Distinct goods and services should be accounted for as separate deliverables (this process is sometimes called "un-bundling"). These distinct goods or services are referred to as "performance obligations."

Step 2

Identify the performance obligations

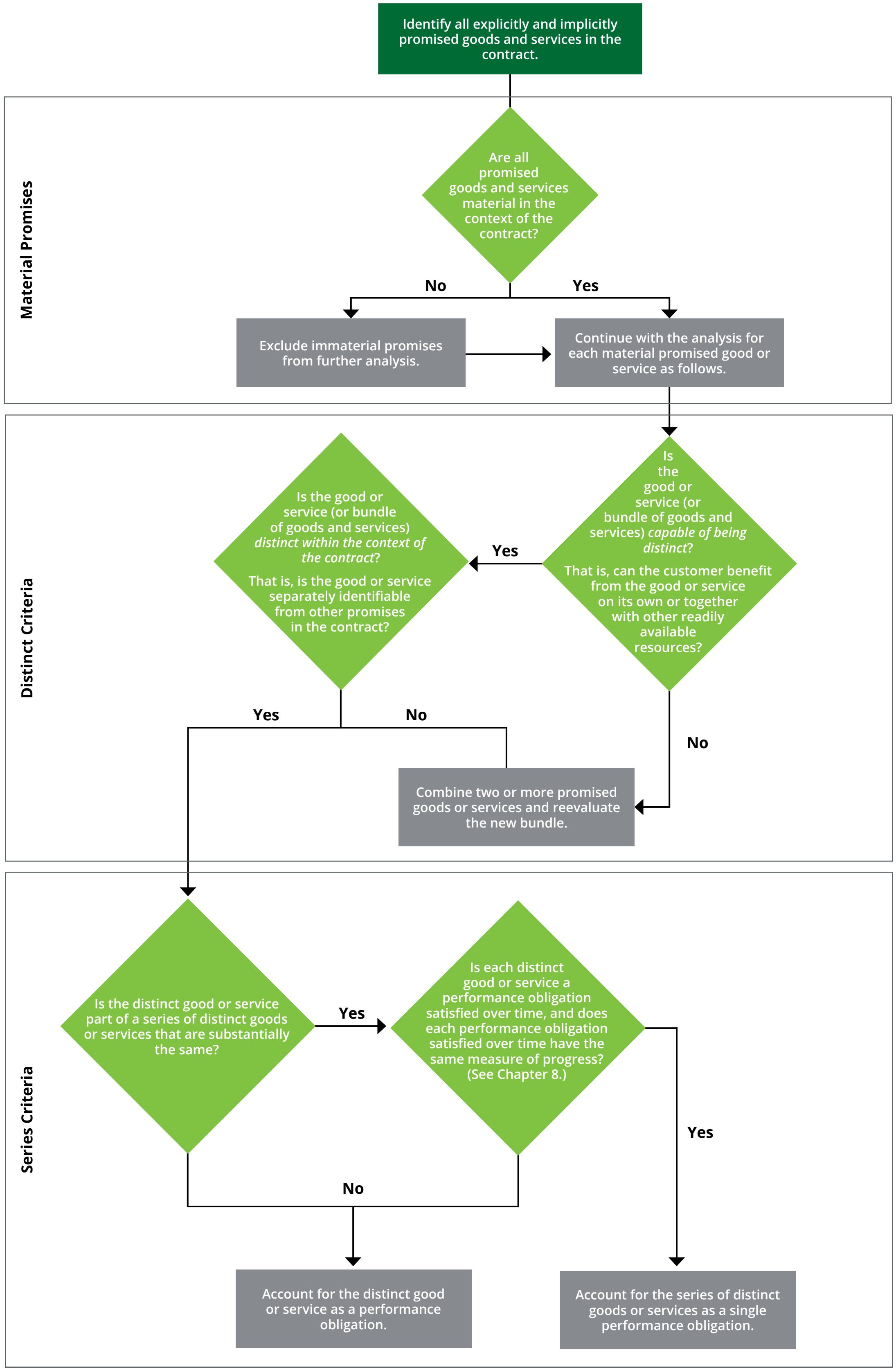
The ASU provides guidance on evaluating the promised "goods or services" in a contract to determine each performance obligation (i.e., the unit of account). A performance obligation is each promise to transfer either of the following to a customer:

- "A good or service (or a bundle of goods or services) that is distinct."
- "A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."

The ASU includes guidance on identifying distinct performance obligations in contracts involving the following:

- Warranties (see Section 5.5).
- Customer options to acquire additional free goods or services (see Section 5.6).
- Nonrefundable up-front fees (see Section 5.7).

The following decision tree illustrates the ASU's process for identifying performance obligations in a contract:



A promised good or service is distinct (and therefore a performance obligation) if both of the following criteria are met:

- *Capable of being distinct* — "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."
- *Distinct within the context of the contract* — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract."

The ASU defines a readily available resource as "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." If an entity regularly sells a good or service on a stand-alone basis, the customer can benefit from that good or service on its own and the criterion in the first bullet point would be met.

The ASU's guidance on determining whether a customer can benefit from a good or service on its own, or with other readily available resources, is generally consistent with the current guidance in ASC 605-25 on determining whether a good or service has "stand-alone value." However, the ASU also contains a new requirement under which entities must evaluate a good or service to determine whether it is "separately identifiable from other promises in the contract." The objective of this determination is to consider whether the nature of the promise is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. The guidance in the ASU (as amended by ASU 2016-10) provides the following indicators that two or more promises are not separately identifiable:

- "The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract. . . . In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer."
- "One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract."
- "The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently."

Entities may need to use significant judgment when determining whether the goods or services in a contract are highly dependent on or highly interrelated with one another, or whether such goods or services significantly modify or customize one another. This new concept may require entities to account for a bundle of goods or services as a single performance obligation (unit of account), which may qualify for separate accounting under current U.S. GAAP.

1.5 Step 3: Determine the Transaction Price (Chapter 6 of the Roadmap)

Step 3

Determine the transaction price

Step 3 requires an entity to **determine the transaction** price for the contract, which is the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or can vary because of "discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items." An entity must consider the following when determining the transaction price under the ASU:

- *Variable consideration (see Section 6.2)* — When the transaction price includes a variable amount, an entity is required to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach, whichever is more predictive of the amount to which the entity will be entitled (subject to the "constraint" discussed in Section 1.5.1 below).
- *Significant financing components (see Section 6.3)* — Adjustments for the time value of money are required if the contract includes a "significant financing component" (as defined by the ASU).
- *Noncash consideration (see Section 6.4)* — To the extent that a contract includes noncash consideration, an entity is required to measure that consideration at fair value at contract inception.
- *Consideration payable to a customer (see Section 6.5)* — Like current U.S. GAAP, the ASU requires that consideration payable to the customer be reflected as an adjustment to the transaction price unless the consideration is payment for a distinct good or service (as defined by the ASU).

1.5.1 Constraining Estimates of Variable Consideration

Some or all of an estimate of variable consideration is only included in the transaction price to the "extent that it is probable[2] that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved" (this concept is commonly referred to as the "constraint"). The ASU requires entities to perform a qualitative assessment that takes into account both the likelihood and the magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, long period before uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts). This estimate would be updated in each reporting period to reflect changes in facts and circumstances. In addition, the constraint does not apply to sales- or usage-based royalties derived from the licensing of intellectual property; rather, consideration from such royalties is only recognized as revenue at the later of when the performance obligation is satisfied or when the uncertainty is resolved (e.g., when subsequent sales or usage occurs). See Chapter 11 for further discussion of licensing.

Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event (i.e., the price is no longer variable). Under the ASU, an entity must include some or all of an estimate of variable (or contingent) consideration in the transaction price (which is the amount to be allocated to each unit of account and recognized as revenue) when the entity concludes that it is probable that changes in its estimate of such consideration will not result in significant reversals of revenue in subsequent periods. This less restrictive guidance will most likely result in earlier recognition of revenue under the ASU than under current U.S. GAAP. Further, entities

[2] In IFRS 15, the IASB uses the term "highly probable," which has the same meaning as the FASB's "probable" as defined in ASC 450.

will need to exercise significant judgment when performing this assessment and could therefore find it challenging to consistently apply the ASU's requirements throughout their organization.

1.6 Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract (Chapter 7 of the Roadmap)

Step 4 requires an entity to **allocate the transaction price** determined in step 3 to the performance obligations identified in step 2 by using the following approaches:

- Allocating the transaction price to the performance obligations on the basis of the stand-alone selling price (see Section 7.1).
- Allocating a discount to one or more, but not all, of the performance obligations in the contract (see Section 7.3).
- Allocating variable consideration to one or more, but not all, of the performance obligations in the contract (see Section 7.4).
- Allocating changes in the transaction price to the performance obligations in the contract (see Section 7.5).

Step 4

Allocate the transaction price to the performance obligations

Under the ASU, when a contract contains more than one performance obligation, an entity would generally allocate the transaction price to each performance obligation on a relative stand-alone selling price basis. The ASU states that the "best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers." If the good or service is not sold separately, an entity must estimate the stand-alone selling price by using an approach that maximizes the use of observable inputs. Acceptable estimation methods include, but are not limited to, (1) adjusted market assessment, (2) expected cost plus a margin, and (3) a residual approach (when the stand-alone selling price is not directly observable and is either highly variable or uncertain). An entity would determine the stand-alone selling price for a good or service at contract inception and would not reassess or update its determination of the stand-alone selling price thereafter.

The ASU indicates that if certain conditions are met, there are limited exceptions to this general allocation requirement. When those conditions are met, a discount or variable consideration must be allocated to one or more, but not all, of the distinct goods or services or performance obligations in a contract.

Changes in the transaction price (e.g., changes in an estimate of variable consideration) after contract inception would be allocated to all performance obligations in the contract on the same basis (unless the terms of the contract meet certain criteria that allow for allocation of a discount or variable consideration to one or more, but not all, of the performance obligations).

The ASU allows entities to use a residual approach in allocating contract consideration, but only when the stand-alone selling price of a good or service is not directly observable and is either "highly variable or uncertain." An entity will need to use judgment in determining whether these criteria are met. Because the ASU's allocation guidance is similar to the guidance in ASC 605-25, entities that have historically applied ASC 605-25 and have established stand-alone selling prices for goods or services (through either separate sales or estimations) or have established VSOE in accordance with ASC 985-605 may not be able to use a residual approach.

1.7 Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation (Chapter 8 of the Roadmap)

Step 5 specifies how an entity should determine when to recognize revenue in relation to a performance obligation and requires consideration of the following:

- Recognition of revenue when (or as) **control** of the good or service is passed to the customer (see Sections 8.1 and 8.2).
- Criteria for satisfying performance obligations and recognizing revenue over time (see Section 8.4).
- Measurement of progress in satisfying performance obligations to determine the pattern of when to recognize revenue over time (see Section 8.5).
- Indicators of when performance obligations are satisfied and when to recognize revenue at a point in time (see Section 8.6).

Step 5

Recognize revenue when (or as) the entity satisfies a performance obligation

Under the ASU, a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying goods or services (the "assets") related to the performance obligation is transferred to the customer. The ASU defines "control" as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." An entity must first determine whether control of a good or service is transferred over time. If so, the related revenue is recognized over time as the good or service is transferred to the customer. If not, control of the good or service is transferred at a point in time.

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "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."

If a performance obligation is satisfied over time, an entity recognizes revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The ASU provides specific guidance on measuring progress toward completion, including the use and application of output and input methods.

The ASU notes that in certain circumstances, an entity may not be able to reasonably measure progress toward complete satisfaction of a performance obligation. In such circumstances, the entity would be required to recognize revenue to the extent of costs incurred (i.e., at a zero profit margin) if the entity expects to recover such costs. The ASU does not permit entities to use a completed-contract method such as that described in ASC 605-35 (formerly SOP 81-1).

If a performance obligation is not satisfied over time, it is deemed satisfied at a point in time. Under the ASU, entities would consider the following indicators in evaluating the point at which control of an asset has been transferred to a customer:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."

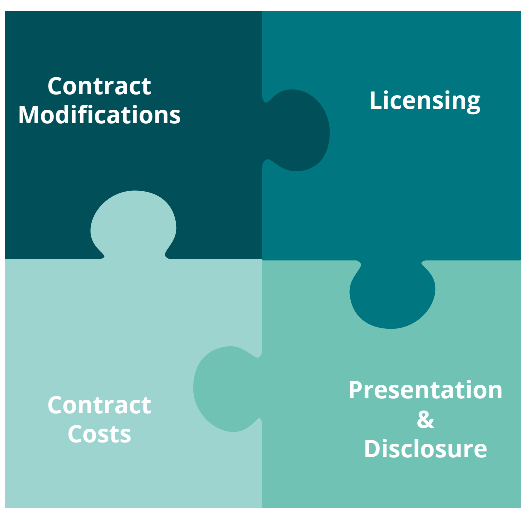
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

In addition, the implementation guidance includes further discussion on the following topics related to when control of an asset has been transferred to a customer:

- *Repurchase agreements (Section 8.7)* — If the entity has an obligation (forward) or right (call option) to repurchase the asset (or in some instances when the customer has rights to put the asset back to the entity), the customer does not obtain control, and the transaction is accounted for as a lease (ASC 840 or ASC 842) or a financing arrangement.
- *Consignment arrangements (Section 8.6.6)* — Control typically passes to another party (a dealer or distributor) when (1) that party sells the product to a customer of its own or (2) a specified period expires.
- *Bill-and-hold arrangements (Section 8.6.7)* — The entity should evaluate whether control has passed to its customer (the ASU provides specific criteria that are similar, but not identical, to current requirements). Further, the entity is required to consider whether there are additional performance obligations after control is transferred to the customer (e.g., an obligation to provide custodial services); if such performance obligations exist, the entity would allocate a portion of the transaction price to those performance obligations.
- *Customer acceptance terms (Section 8.6.5)* — Control has been transferred to the entity's customer if the entity can objectively determine that the good or service meets agreed-upon specifications. If the entity is unable to make that objective determination, the entity must receive the customer's acceptance before concluding that control has been transferred.

1.8 Beyond the Core Model

The new revenue standard also affects other related accounting topics and creates new disclosure requirements, as discussed in Sections 1.8.1 and 1.8.2 below.



1.8.1 Other Related Accounting Topics

Additional accounting topics affected by the new revenue standard are summarized in the following table:

Topic	Roadmap Chapter
Combination of contracts There are certain circumstances in which multiple legal-form contracts would be accounted for as though they were one accounting contract. The ASU provides guidance on when contracts should be combined.	Chapter 4
Rights of return The obligation of a seller to "stand ready" to accept a return is not a performance obligation. However, when a seller stands ready to accept a return, it does not recognize revenue for goods expected to be returned. Rather, it recognizes a refund liability for consideration paid by a buyer to which the seller does not expect to be entitled, together with a corresponding asset to recover the product from the buyer.	Chapter 6
Customers' unexercised rights An entity recognizes "breakage" (i.e., a customer's unexercised rights) in a manner consistent with the pattern of rights exercised by the customer if the entity expects to be entitled to a breakage amount; otherwise, the entity defers recognition until the probability that the customer will exercise its rights is remote.	Chapter 8
Contract modifications The ASU provides a general framework of accounting for contract modifications, including guidance on when modifications are accounted for as a separate contract and how changes should be recorded.	Chapter 9
Principal-versus-agent considerations The ASU includes guidance on determining whether the promise an entity has made to a customer is to provide the good or service or to arrange for another party to fulfill the promise.	Chapter 10
Licensing The ASU's guidance on licensing distinguishes between two types of licenses (right of use and right to access). The timing of revenue recognition is different for each.	Chapter 11
Cost to obtain or fulfill a contract The ASU includes guidance on how to account for costs related to a contract, distinguishing between costs of obtaining a contract and costs of fulfilling a contract. For situations in which the application of this guidance results in the capitalization of costs, the ASU provides additional guidance on (1) determining an appropriate amortization period and (2) impairment considerations.	Chapter 12
Nonpublic-entity requirements The ASU provides nonpublic entities with disclosure practical expedients and a delayed effective date.	Chapter 16

(Table continued)

Topic	Roadmap Chapter
Nonfinancial assets The ASU provides guidance on the recognition and measurement of transfers of nonfinancial assets to parties that are not customers (codified in ASC 610-20, *Other Income: Gains and Losses From the Derecognition of Nonfinancial Assets*). ASC 610-20 amends or supersedes the guidance in ASC 350 and ASC 360 on determining the gain or loss recognized upon the derecognition of a nonfinancial asset (e.g., a real estate asset).	Chapter 17
Income tax considerations Entities need to consider the income tax implications of applying the new revenue standard.	Chapter 18

1.8.2 Required Disclosures (Chapter 14 of the Roadmap)

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements, which are significantly more comprehensive than those in existing revenue standards, include the following (there are certain exceptions for nonpublic entities; see Chapter 16 for a summary of these exceptions):

- Presentation or disclosure of revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts.
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the ASU also provides implementation guidance).
- Information about (1) contract assets and contract liabilities (including changes in those balances), (2) the amount of revenue recognized in the current period that was previously recognized as a contract liability, and (3) the amount of revenue recognized in the current period that is related to performance obligations satisfied in prior periods.
- Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) a quantitative disclosure of the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied)" and when the entity expects to recognize that amount as revenue.
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).
- Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortization methods).
- Information about policy decisions (i.e., whether the entity used the practical expedients for significant financing components and contract costs allowed by the ASU).

The ASU requires entities, on an interim basis, to disclose information required under ASC 270 as well as to provide the disclosures (described above) about (1) the disaggregation of revenue, (2) contract asset and liability balances and significant changes in those balances since the previous period-end, and (3) the transaction price allocated to the remaining performance obligations.

IFRS 15 only requires entities to disclose the disaggregation of revenue in addition to the information required under IAS 34 for interim periods (see Appendix A).

1.9 Effective Date (Chapter 15 of the Roadmap)

The ASU's effective date was deferred by one year when the FASB issued ASU 2015-14. As a result of the deferral, public entities reporting under U.S. GAAP are now required to adopt the new revenue standard for annual reporting periods (including interim reporting periods within those annual periods) beginning after December 15, 2017. Early application is permitted as of the new revenue standard's original effective date (i.e., reporting periods beginning after December 15, 2016). In addition, ASU 2015-14 (as did ASU 2014-09 before its guidance was amended) provides relief for nonpublic entities by delaying the effective date; see Chapter 16 for more information.

In a manner similar to that of other IFRSs, IFRS 15 allows entities an option to apply its new requirements earlier. For differences between U.S. GAAP and IFRS effective date and transition requirements, see Appendix A.

1.10 Transition Approach (Chapter 15 of the Roadmap)

Entities have the option of using either a full retrospective or modified retrospective method to adopt the guidance in the new revenue standard:

- *Full retrospective application* — Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients).
- *Modified retrospective application* — Under the modified retrospective method, an entity recognizes "the cumulative effect of initially applying [ASU 2014-09] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). When using this method, an entity applies the guidance in the ASU (as amended by ASU 2016-12) to either of the following:
    - Incomplete contracts (i.e., those contracts for which all (or substantially all) of the revenue has not been recognized in accordance with prior revenue guidance) as of the date of initial application.
    - All contracts as of, and new contracts after, the date of initial application.

Under the modified retrospective method, the ASU need not be applied to contracts that were completed before the effective date (i.e., contracts for which an entity has recognized all (or substantially all) of the revenue in accordance with legacy revenue guidance in effect before the date of initial application). Entities that elect the modified retrospective method must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application. The following chart illustrates the application of the ASU and legacy GAAP under the **modified retrospective method** for a public entity with a calendar year-end:

January 1, 2018	2018	2017	2016
Initial Application Year	Current Year	Prior Year 1	Prior Year 2
New contracts	New ASU		
Existing contracts	New ASU + cumulative catch-up	Legacy GAAP	Legacy GAAP
Completed contracts		Legacy GAAP	Legacy GAAP

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and to determine the transition approach that is practical to apply and most beneficial to financial statement users.

The FASB recently issued amended guidance (in ASU 2016-12) that provides entities applying either transition method with a practical expedient to allow them to determine and allocate the transaction price of a modified contract as of the beginning of the earliest period presented instead of requiring them to separately evaluate the effects of every modification of the contract. See Chapter 15 for further discussion.

Entities should carefully evaluate the respective advantages and disadvantages of each of the transition methods before selecting their method of adopting the ASU. The transparent trend information provided under the full retrospective method may be most effective for entities that expect to experience a significant change. Also, entities that have significant deferred revenue balances may prefer a full retrospective method to ensure that such revenue is not "lost" from operations by its recognition as a cumulative-effect adjustment to retained earnings. However, the full retrospective method will require a significant effort since the adjustments to prior reported results will change not only the revenue recognized but also the other "direct effects of a change" as defined in ASC 250.

For the latest developments from the SEC and FASB on implementation of the new revenue standard, including guidance on required SEC registrant disclosures, refer to Chapter 19.

Chapter 2 — Symbols and Defined Terms

This chapter discusses the symbols used in this publication and the definition of various terms used in ASC 606.

2.1 Symbols

Because of the evolving nature of the new revenue standard, several ongoing activities will continue to affect the wording or interpretations of the standard. Specifically, both the FASB and IASB are conducting activities that may result in future amendments to the boards' new revenue guidance in ASU 2014-09 (codified primarily in ASC 606) and IFRS 15, respectively. Some of these potential amendments have been discussed in public meetings of the FASB or IASB or have been identified by the TRG as possible standard-setting topics. In many cases, such amendments have been finalized by the FASB or the IASB, and this publication incorporates those amendments; however, future editions of this Roadmap will address, as necessary, any future developments of the boards. As with other GAAP, any new or evolving information about the new revenue standard's implementation that comes to the attention of the FASB and IASB will be addressed by the boards as deemed necessary. In addition, other interpretive bodies, such as the TRG and the AICPA's working groups, are engaging in ongoing discussions.

This Roadmap includes discussion of these bodies' various views on topics related to the new revenue standard. To indicate the source of such views (e.g., the FASB, TRG, or AICPA) and their level of authority, we have created the following symbols:

TRG Update

This symbol identifies content related to TRG discussions. The TRG is a group that the FASB and IASB jointly established in June 2014 upon issuance of the final revenue standard. This group met twice in 2014 and four times in 2015. In addition, the FASB-only version of the TRG met in April 2016 and has scheduled another meeting for November 2016. The IASB has indicated that it will not hold future TRG meetings. For more information about the TRG, see Appendixes D and E, which list chronologically and by topic all issues considered by the group to date.

Construction Ahead

This symbol highlights topics on which the FASB has proposed changes to the guidance in ASU 2014-09 or other consequential amendments.

Changing Lanes

Discussions identified by this symbol address potential changes that could affect a company's recognition, measurement, or presentation under the new revenue standard. Note, however, that while such potential changes are significant, they may or may not affect all companies equally. Also, readers should use caution since our Roadmap is not intended to include a comprehensive list of all key changes or to identify all key changes that a particular company may experience. The only way for a company to identify all changes that may affect it is to perform a careful evaluation that compares practices required under the new revenue standard with current practices.

Thinking It Through

The content indicated by this symbol comprises topics that warrant particular focus or necessitate further consideration in the adoption of the new revenue standard. In addition, the content sometimes represents Deloitte's views on such topics and the firm's projections about what may occur in the future.

Driving Discussion

This symbol highlights discussions in the Roadmap about issues that stakeholders have raised in preparing for implementation of the new revenue standard. Since interpretive bodies have not yet reached general agreement on some of these implementation issues, we discuss such unresolved matters, including various views expressed, to raise awareness of them and encourage entities affected by them to seek advice from Deloitte's National Office. We expect future versions of our Roadmap to address these matters more comprehensively and, in many cases, to reach a conclusion regarding the most appropriate interpretation of the new guidance.

As Amended

A section headed with this symbol highlights guidance that has evolved since the issuance of ASU 2014-09. That is, the symbol will enable readers to identify aspects of the ASU's guidance that have been affected by subsequent standard setting. The content under this symbol reflects the application of the final guidance in ASC 606 as amended by the FASB and may not, in all circumstances, reflect the guidance as originally issued in ASU 2014-09.

Diverging From IFRS 15

This symbol indicates that the content immediately below it discusses guidance in ASC 606 that differs from the guidance in IFRS 15. Accordingly, it will enable readers who are subject to both international and U.S. reporting requirements to identify aspects of the new revenue standard regarding which they may need to consider a difference between U.S. GAAP and IFRSs.

Further, pending content in reproduced Codification paragraphs that reflects the issuance of ASUs whose effective date is later than that of the new revenue standard (e.g., ASU 2016-02, *Leases (Topic 842)*) is noted {in braces}.

2.2 Defined Terms

2.2.1 Glossary Terms

ASC 606 contains a glossary of terms used in the new revenue standard. Several of these glossary terms are also used in other topics of U.S. GAAP (e.g., "public business entity" and "probable"). However, most of them are specific to ASC 606 (e.g., "contract asset" and "contract liability").

Although there are not many terms in the standard's glossary, a significant number of them play a critical role in establishing the scope of the guidance (e.g., "contract" and "customer," as discussed in Chapter 3), establishing presentation of financial statement line items (e.g., "contract asset" and "contract liability," as discussed in Chapter 13), and creating a new definition of the unit of account for revenue (e.g., "performance obligation," as discussed in Chapter 5). Also, as noted in the discussion of collectibility in Chapter 4, the definition of "probable" under U.S. GAAP differs from that under IFRSs.

Throughout this Roadmap, terms defined in the standard's glossary that appear in text reproduced from the Codification are linked to the glossary below (reproduced from ASC 606-10-20) in a manner consistent with how the FASB links defined terms in the Codification to the ASC master glossary. That is, all linked terms in Codification excerpts throughout this Roadmap are defined terms from the new revenue standard and the ASC master glossary and are included in the list below.

ASC 606-10-20

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Contract Asset

An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Contract Liability

An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Customer

A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Lease (ASC 840)

An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

Lease (ASC 842)

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

ASC 606-10-20 (continued)

Performance Obligation

A promise in a contract with a customer 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.

Probable

The future event or events are likely to occur.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers) with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Revenue

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Standalone Selling Price

The price at which an entity would sell a promised good or service separately to a customer.

Transaction Price

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

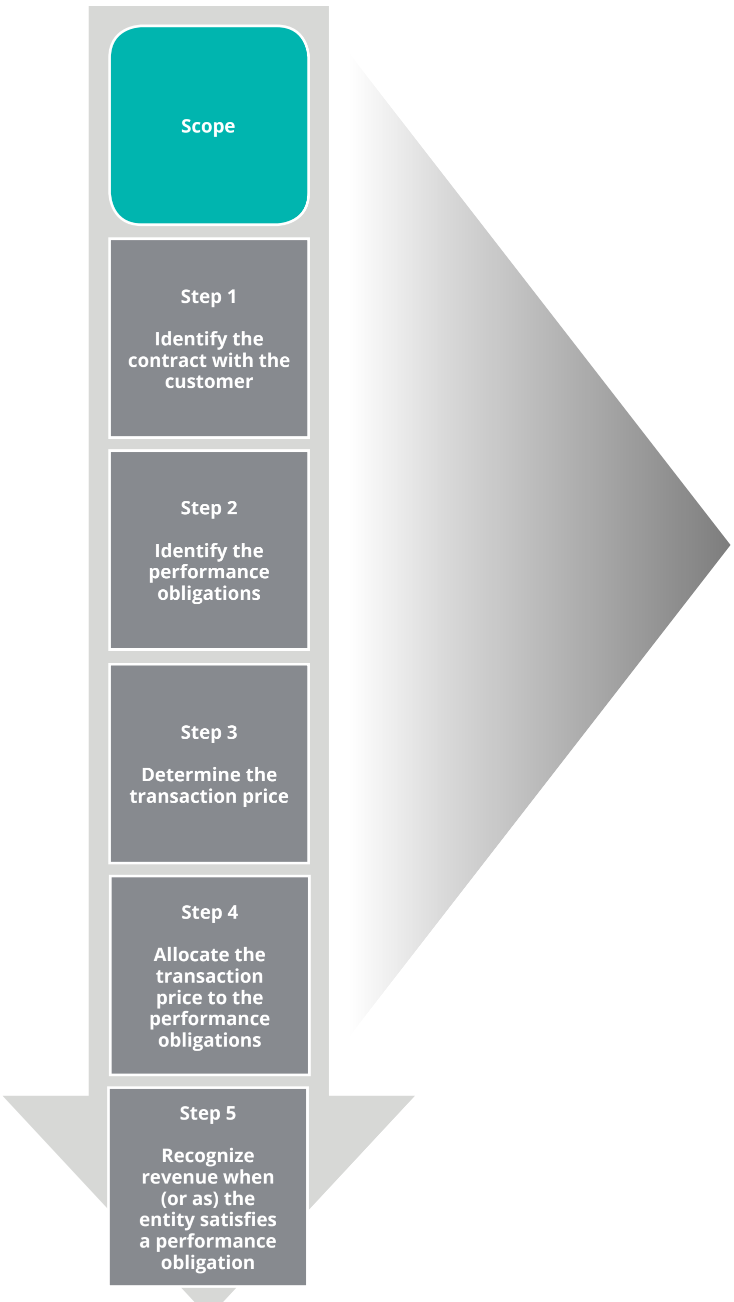
2.2.2 "Criteria" Versus "Factors" and "Indicators"

Various guidance throughout the new revenue standard lists "criteria," "factors," or "indicators." Criteria are distinguishable from factors and indicators.

Criteria are specific requirements that must be met for an entity to make a determination. That is, criteria are determinative or are requirements in a particular assessment. For example, as discussed in step 1 (Chapter 4), ASC 606-10-25-1 lists five criteria that must all be met for an entity to conclude that a contract with a customer exists. Similarly, as discussed in step 2 (Chapter 5), ASC 606-10-25-19 lists two criteria that must be met for an entity to determine that a good or service promised to a customer is distinct and therefore a performance obligation. In that assessment, if one or both of those criteria are not met, the promise is not distinct and is therefore not a separate performance obligation.

In contrast, factors and indicators are considerations that may support a conclusion but are not determinative. For example, the guidance on constraining estimates of variable consideration lists factors in ASC 606-10-32-12 “that could increase the likelihood or the magnitude of a revenue reversal”; and the guidance on principal-versus-agent considerations lists indicators in ASC 606-10-55-39 (as amended by ASU 2016-08) that the entity is a principal. While the presence of one or more of these factors or indicators may suggest that revenue is likely to be reversed (in the case of ASC 606-10-32-12) or that the entity is a principal (in the case of ASC 606-10-55-39), the absence of one or more of these factors or indicators does not preclude such a determination. For more information about constraints on variable consideration and principal-versus-agent considerations, see Chapters 6 and 10.

Chapter 3 — Objective and Scope



3.1 Objective

ASC 606-10

General

10-1 The objective of the guidance in this Topic is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer.

In the revenue recognition project, the FASB, together with the IASB, set key objectives to guide its development of the new guidance. ASU 2014-09, which created ASC 606, outlines those key objectives in its Summary as follows:

1. Remove inconsistencies and weaknesses in revenue requirements.
2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The objectives listed above could be further summarized as follows:

- *Establish a comprehensive framework* — Create a new comprehensive framework for assessing all revenue transactions (across industries, jurisdictions, and capital markets) to eliminate inconsistencies and fill gaps in legacy U.S. GAAP.
- *Enhance revenue disclosures* — Improve disclosures by requiring entities to provide more information about revenue, a key financial metric.

The objective of the new revenue standard as stated in ASC 606 — "to establish principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer" — lays the groundwork for the overall framework and the detailed recognition, measurement, presentation, and disclosure principles outlined in the remainder of the standard. The Board believed that this comprehensive framework would eliminate the need to address revenue topics in a piecemeal manner through the EITF or the AICPA's industry guides. While it would still be necessary for the EITF and AICPA to work through new and emerging revenue issues, those groups would all be using the same comprehensive framework when analyzing revenue questions.

3.1.1 Meeting the Objective

After establishing the objective of the new revenue standard, the FASB and IASB created a core principle that establishes this comprehensive framework and governs the entire guidance. The core principle is expressed in ASC 606-10-10-2 as follows:

ASC 606-10

Meeting the Objective

10-2 To meet the objective in paragraph 606-10-10-1, the core principle of the guidance in this Topic is that an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Many do not focus on this core principle and rush directly into the detailed requirements of the standard. However, the manner in which the boards developed the core principle and the specific words they used to articulate it were intentional. At its core, this main principle outlines the answers to the following key questions that always arise when a revenue transaction is evaluated:

- *When (i.e., recognition)* — When is it appropriate to recognize revenue?
- *How much (i.e., measurement)* — What specific amount of revenue is an entity allowed to recognize?

The core principle's answers to these questions are discussed below.

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

When?	The entity satisfies a performance obligation by transferring a good or service to the customer.
How much?	Amount to which the entity expects to be entitled (i.e., transaction price) allocated to the distinct goods or services.

3.1.1.1 When to Recognize Revenue

In accordance with the core principle of the new revenue standard, revenue is recognized when the entity transfers promised goods or services to the customer.

Specifically, the boards intended to depict performance through the recognition of revenue. That is, when the entity performs by delivering goods or services, it should recognize revenue because doing so demonstrates to a financial statement user that the performance has taken place. However, current revenue practices preclude the entity from recognizing revenue when (1) revenue is contingent on future events (e.g., it is not fixed or determinable) or (2) VSOE of fair value is unavailable for undelivered software elements. In both of these examples, revenue recognition is disconnected from the entity's performance (i.e., the entity is precluded from recognizing revenue even though it has performed). In developing the new revenue standard, the boards believed that it is important to demonstrate to financial statement users when the entity performs; accordingly, that depiction is the recognition of revenue. Uncertainties about whether and, if so, how much revenue should be recognized would be dealt with separately in the measurement of revenue.

3.1.1.2 How Much Revenue to Recognize

Under the core principle, revenue is recognized in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the promised goods or services.

The measurement concept within the core principle was fiercely debated and changed over time. In the end, the wording "expects to be entitled," which was introduced in the boards' 2011 revised exposure draft (ED) and represented a change from their 2010 ED, was deliberate and intended to reflect a measure of revenue that did not include variability attributable to customer credit risk. At the time the boards were developing the new revenue standard, they were also debating financial instruments and the impairment model for those financial instruments. As a result, there were many debates about whether the measurement of revenue should reflect the risk that the customer cannot or will not pay the amounts as they become due. The final decisions of the boards distinguished customer credit risk from other sources of variability in a revenue contract. Accordingly, the phrase "expects to be entitled" was intentional — specifically, the phrase "be entitled" is intentionally different from the word "collect" or the word "receive" since each of those words would imply that the amount estimated encompasses all risks, including the risk that the customer cannot or will not pay. Therefore, unlike a fair value measurement model, the allocated transaction price approach under the new revenue standard generally does not reflect any adjustments for amounts that the entity might not be able to collect from the customer (i.e., customer credit risk). However, the transaction price is inclusive of all other uncertainties. The boards outlined this allocated transaction price approach in paragraph BC181 of ASU 2014-09.

In addition, the amount to which an entity expects to be entitled is not always the price stated in the contract or the invoiced amount, either of which may be expected on the basis of a common interpretation of the word "entitled." For purposes of ASC 606, the term "entitled" is aligned with the determination of the "accounting" contract (as opposed to the "legal" contract). Therefore, "entitlement" is influenced by the entity's past practices, which affect the enforceable rights and obligations in the accounting contract. As a result, under ASC 606, the amount to which an entity expects to be entitled is inclusive of any price concessions that the entity explicitly or implicitly provides. That is, if the entity will accept an amount of consideration that is less than the contractually stated or invoiced price, that amount is a price concession and is treated as variable consideration. See Chapter 6 for further discussion of the determination of the transaction price and Chapter 11 for discussion of an exception to the general rule on estimating variable consideration for sales- or usage-based royalties..

One exception to this "entitlement" notion within measurement is when a significant financing component is identified in a contract because, for example, a customer pays in arrears. In that case, customer credit risk will be reflected in the amount of revenue recognized. This is because an entity will take customer credit risk into account in determining the appropriate discount rate (see Section 6.3.4).

In addition, as noted in paragraphs BC260 and BC261 of ASU 2014-09, the FASB and IASB decided that revenue should be measured at the amount to which an entity expects to be entitled in response to comments from users of financial statements that "they would prefer revenue to be measured at the 'gross' amount so that revenue growth and receivables management (or bad debts) could be analyzed separately."

3.1.1.3 Changes Attributable to the Core Principle

The creation of the core principle and its embedded key concepts could lead individuals to think that applying the new standard will significantly change the amount of revenue they recognize. However, the amount of change will vary depending on the entity's business and how the entity previously accounted for transactions. While paragraph BC478 of ASU 2014-09 states that ASC 606 "appears to be a significant change from previous revenue recognition guidance," it adds that "previous practices were broadly consistent with this approach, and many entities determined the amount of revenue on the basis of the amounts the customer promised to pay."

Thinking It Through — No Simple Answer

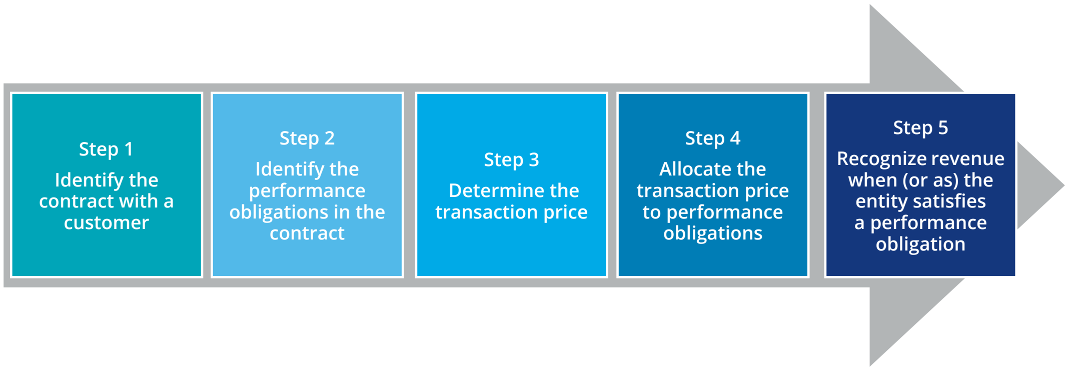
Typically, the first reaction of those new to the implementation efforts on revenue is some version of the question "How does the new standard change how I recognize revenue?" Unfortunately, this is not a simple question with a quick checklist to assess the change. Rather, entities will each have to critically read and comprehend the standard because they know their business best and can apply the steps to arrive at the correct answer. While there may be wholesale changes in some situations, there may be other situations in which the new framework leads to the same outcome as current practice. However, even when the outcome (i.e., the amount of revenue recognized) does not change, the processes and controls related to the financial reporting cycle are likely to change (see Chapter 20 for further discussion). In addition, all entities are required to provide significantly more disclosures under the new revenue standard and will therefore need to capture and report new information (see Chapter 14 for further discussion).

Changing Lanes — From Risks and Rewards to a Control Model

Much of previous U.S. GAAP included the concept that revenue should be recognized when the transfer of risks and rewards has occurred. Under ASU 2014-09, an entity would recognize revenue when it determines that its customer has obtained control of an asset by demonstrating that the customer can obtain substantially all of the benefits from the asset. That is, the underlying concept has shifted from a "risks and rewards" model to a control model. While the underlying revenue recognition criteria between the standards appear similar, there are subtle differences that could drive changes for entities ranging from insignificant to major. Entities should think through the details of all five steps of the new revenue standard to appropriately recognize revenue because simply attempting to think about the new control concept in isolation could lead them to the wrong answer.

3.1.2 Applying the New Standard

After establishing the core principle, the FASB and IASB agreed on the following five steps (as outlined in Chapter 1) to apply that principle:



The introduction to the standard describes the five steps to be applied. However, those five steps do not appear sequentially in either the body of the standard or the implementation guidance.

The Q&A below explains the importance of executing the five steps in order.

Q&A 3-1 Sequence of Revenue Steps and Whether All Five Must Be Performed

Question

Must an entity work through **all** of the five steps of the revenue model for every contract, and must the five steps be applied sequentially?

Answer

An entity should consider all five steps for every contract with a customer unless a step is clearly inapplicable.

In a manner consistent with the structure of the Codification, the requirements of ASC 606 adhere to the framework of recognition, measurement, presentation, and disclosure. As a result, the steps are not presented sequentially in ASC 606 but rather as follows:

Recognition — Step 1 (identification of a contract), step 2 (identification of separate performance obligations), and step 5 (recognize revenue when (or as) the entity satisfies a performance obligation).

Measurement — Step 3 (determine the transaction price) and step 4 (allocation of the transaction price to the performance obligations in the contract).

Application of All Five Steps

Generally, an entity should apply all five steps for every contract. However, the entity may find that, after considering the specific facts and circumstances of a particular contract and understanding the framework and the five steps, one of the steps is not relevant. This may occur, for example, in a contract for which the entity has determined in step 2 that it has only a single performance obligation. In such circumstances, step 4 (allocation of the transaction price) will often not be applicable and the entity can, in effect, jump from step 3 to step 5.

Order of the Steps

An entity would generally be expected to apply the five steps in sequential order. However, the entity may sometimes need to consider a later step before applying an earlier one.

Example 1

In applying step 1 to determine whether a contract exists and reviewing the collectibility threshold as required in ASC 606-10-25-1(e), an entity will need to consider the "amount of consideration to which it will be entitled in exchange for the promised goods or services." The amount of consideration "may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession." As a result, the entity would need to apply step 3 (determination of the transaction price) and estimate the expected discounts or price concessions before being able to conclude that a valid contract exists under step 1.

Example 2

Under step 2 (identification of the performance obligations), ASC 606-10-25-14(b) requires entities to identify as a performance obligation a "series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer." In accordance with ASC 606-10-25-15, that series is a performance obligation only when the following two criteria are met: (1) the performance obligation satisfies the criteria in step 5 to be recognized over time and (2) the same method to measure progress is used. Therefore, the determination in step 2 about whether a series of distinct goods or services is a single performance obligation relies on the requirements in step 5. As a result, an entity would need to understand and make a determination about step 5 before being able to apply step 2 (the identification of its performance obligations).

3.1.2.1 Consistency in Application

ASC 606-10

10-3 An entity shall consider the terms of the contract and all relevant facts and circumstances when applying this guidance. An entity shall apply this guidance, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances.

When the FASB was developing the detailed recognition and measurement guidance, it found many instances in which estimates and judgments would be required. In each of those instances, the Board believed that entities should consider all relevant facts and circumstances in applying those estimates and judgments. As a result, in the "General" section of the standard, the Board outlined requirements that should be applicable throughout the standard.

For example, the guidance on allocating the transaction price to performance obligations in accordance with step 4 (see Chapter 7) requires an entity to determine the stand-alone selling price of a good or service by choosing an appropriate method (e.g., the adjusted market assessment approach, the expected cost plus a margin approach, or, in limited circumstances, the residual approach). Once an entity decides which method to use, it is required to apply the same method consistently to similar contracts in accordance with the general guidance in ASC 606-10-10-3 on consistency in application. Rather than repeat this general requirement throughout the detailed guidance on recognition and measurement, the Board decided to state it once at the beginning of the standard to make it applicable to the standard's guidance overall.

3.1.2.2 Portfolio Approach

ASC 606-10

10-4 This guidance specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

During the initial development of the new guidance, the FASB's and IASB's proposed concepts were consistently discussed on the basis of an individual contract. However, feedback on the early drafts of the guidance indicated that it would sometimes not be practical and cost-effective to apply the guidance on an individual contract basis. In response to this feedback, discussions ensued regarding the use of a portfolio approach.

The boards ultimately concluded that the new revenue standard should generally be applied on an individual contract basis. However, as a practical expedient, a portfolio approach is permitted if it is reasonably expected that the approach's impact on the financial statements will not be materially different from the impact of applying the revenue standard on an individual contract basis.

Some stakeholders had requested additional guidance on when and how to establish portfolios. However, the boards declined to list specific conditions that must be met for an entity to apply the new revenue guidance to a portfolio of contracts. Instead, the boards used a principle to establish that a portfolio approach may be used depending on whether the effects of applying the guidance to a portfolio of contracts would differ materially from the effects of applying the guidance to contracts individually. Further, as noted in paragraph BC69 of ASU 2014-09, the boards "indicated that they did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts."

Q&A 3-2 Deciding Whether a Portfolio Approach May Be Used

Some entities manage a very large number of customer contracts and offer an array of product combination options (e.g., entities in the telecommunications industry may offer a wide selection of handsets and wireless usage plan options). For these entities, it would take significant effort to apply some of the requirements of ASC 606, such as the requirement to allocate the stand-alone selling price to the identified performance obligations, on an individual contract basis, and the capability of IT systems to capture the relevant information may be limited.

ASC 606 includes a practical expedient that provides some relief from the burden of accounting for individual contracts. ASC 606-10-10-4 allows entities to apply ASC 606 to a portfolio of contracts or performance obligations ("portfolio approach"). However, a portfolio approach would be appropriate only if (1) it is applied to a group of contracts (or performance obligations) with "similar characteristics" and (2) the entity "reasonably expects" that the effects on the financial statements of applying ASC 606 to the portfolio "would not differ materially" from the effects of applying guidance to the individual contracts (or performance obligations) in that portfolio.

Question

How should an entity evaluate whether it is eligible to use a portfolio approach under ASC 606-10-10-4?

Answer

ASC 606 does not provide explicit guidance on how to (1) evaluate "similar characteristics" and (2) establish a reasonable expectation that the effects of using a portfolio approach would not differ materially from those of applying the guidance at a contract or performance obligation level. Accordingly, an entity will need to exercise significant judgment in determining that the contracts or performance obligations it has segregated into portfolios have similar characteristics at a sufficiently granular level to ensure that the outcome of using a particular portfolio approach can reasonably be expected not to differ materially from the results of applying the guidance to each contract or performance obligation in the portfolio individually.

In segregating contracts (or performance obligations) with similar characteristics into portfolios, an entity should apply objective criteria associated with the particular contracts or performance obligations and their accounting consequences. When determining whether particular contracts have similar characteristics, the entity may find it helpful to focus particularly on those characteristics that have the most significant accounting consequences under ASC 606 in terms of their effect on the timing of revenue recognition or the amount of revenue recognized. Accordingly, the assessment of which characteristics are most important for determining similarity will depend on the entity's specific facts and circumstances. However, there may be practical constraints on the entity's ability to use existing systems to analyze a portfolio of contracts, and these constraints could affect its determination of how the portfolio should be segregated.

The table below lists objective criteria that entities may consider when assessing whether particular contracts or performance obligations have similar characteristics in accordance with ASC 606-10-10-4. Since any of the requirements in ASC 606 could have significant consequences for a particular portfolio of contracts, the list provided is not exhaustive.

Objective Criteria	Examples
Contract deliverables	Mix of products and services; options to acquire additional goods and services; warranties; promotional programs
Contract duration	Short-term, long-term, committed, or expected term of contract
Terms and conditions of the contract	Rights of return, shipping terms, bill and hold, consignment, cancellation privileges, and other similar clauses
Amount, form, and timing of consideration	Fixed, time and material, variable, up-front fees, noncash, significant financing component

(Table continued)

Objective Criteria	Examples
Characteristics of the customers	Size, type, creditworthiness, geographic location
Characteristics of the entity	Volume of contracts that include the various characteristics; historical information available
Timing of transfer of goods or services	Over time or at a point in time

The example below illustrates how such criteria may be applied.

Example

Entity A, a telecommunications company, offers various combinations of handsets and usage plans to its customers under two-year noncancelable contracts. It offers two handset models: an older model that it offers free of charge (stand-alone selling price is $250); and the most recent model, which offers additional features and functionalities and for which the entity charges $200 (stand-alone selling price is $500). The entity also offers two usage plans: a 400-minute plan and an 800-minute plan. The 400-minute plan sells for $40 per month, and the 800-minute plan sells for $60 per month (which also corresponds to the stand-alone selling price for each plan).

The table below illustrates the possible product combinations and allocation of consideration for each under ASC 606.

	Product Usage	Total Transaction Price	Revenue on Handset* (% of Total Contract Revenue)	Revenue on Usage (% of Total Contract Revenue)
Customer A	Old handset, 400 minutes	$ 960	$ 198 (21%)	$ 762 (79%)
Customer B	Old handset, 800 minutes	1,440	213 (15%)	1,227 (85%)
Customer C	New handset, 400 minutes	1,160	397 (34%)	763 (66%)
Customer D	New handset, 800 minutes	1,640	423 (26%)	1,217 (74%)

* In this example, the proportion of the total transaction price allocated to handset revenue is determined by comparing the stand-alone selling price for the handset to the total of the stand-alone selling prices of the components of the contract.

Customer A: ($250 ÷ ($250 + $960) × $960) = $198

Customer B: ($250 ÷ ($250 + $1,440) × $1,440) = $213

Customer C: ($500 ÷ ($500 + $960) × $1,160) = $397

Customer D: ($500 ÷ ($500 + $1,440) × $1,640) = $423

Example (continued)

As the table indicates, the effects of each product combination on the financial statements differ from those of the other product combinations. The four customer contracts have different characteristics, and it may be difficult to demonstrate that the entity "reasonably expects" that the financial statement effects of applying the guidance to the portfolio (the four contracts together) "would not differ materially" from those of applying the guidance to each individual contract. The percentage of contract consideration allocated to the handset under the various product combinations ranges from 15 percent to 34 percent. The entity may consider that this range might be too wide to apply a portfolio approach; if so, some level of segregation would be required. Alternatively, the entity might determine that there are two portfolios, one for old handsets and the other for new handsets. Under this alternative approach, the entity would need to perform additional analysis to assess whether the accounting consequences of using two rather than four portfolios would result in financial statement effects that differ materially.

The example above is relatively straightforward. In practice, however, the contracts illustrated could involve additional layers of complexity, such as (1) different contract durations; (2) different call and text messaging plans; (3) different pricing schemes (e.g., fixed or variable pricing based on usage); (4) different promotional programs, options, and incentives; and (5) contract modifications. Accounting for such contracts could be further complicated by the high pace of change in product offerings.

In general, the more specific the criteria an entity uses to segregate its contracts or performance obligations into portfolios (i.e., the "greater" the extent of disaggregation), the easier it should be for the entity to conclude that the results of applying the guidance to a particular portfolio are not expected to differ materially from the results of applying the guidance to each individual contract (or performance obligation) in the portfolio. However, further disaggregation into separate sub-portfolios is likely to improve the overall accuracy of estimates only if those sub-portfolios have some different characteristics. For instance, segregating on the basis of geographic location may not be beneficial if similar combinations of products and services that have similar terms and conditions are sold to a similar group of customers in different geographic areas. Likewise, segregating on the basis of whether contract terms allow a right of return may not be necessary if the returns are not expected to be significant.

While there is no requirement in ASC 606 to "quantitatively evaluate"[1] whether using a portfolio approach would produce an outcome materially different from that of applying the guidance at the contract or performance obligation level, an entity should be able to demonstrate why it reasonably expects the two outcomes not to differ materially. The entity may do so by various means depending on its specific facts and circumstances (subject to the constraints of a cost-benefit analysis). Such means include, but are not limited to, the following:

- Data analytics based on reliable assumptions and underlying data (internally or externally generated) related to the portfolio.
- A sensitivity analysis that evaluates the characteristics of the contracts or performance obligations in the portfolio and the assumptions the entity used to determine a range of potential differences in applying the different approaches.
- A limited quantitative analysis, supplemented by a more extensive qualitative assessment that may be performed when the portfolios are disaggregated.

[1] Paragraph BC69 of ASU 2014-09 states that the FASB and the IASB "acknowledged that an entity would need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that application of the revenue recognition model to the portfolio would not differ materially from the application of the revenue recognition model to the individual contracts or performance obligations in that portfolio. In their discussions, the Boards indicated that they did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts."

Typically, some level of objective and verifiable information would be necessary to demonstrate that using a portfolio approach would not result in a materially different outcome. An entity may also wish to (1) consider whether the costs of performing this type of analysis potentially may outweigh the benefits of accounting on a portfolio basis and (2) assess whether it is preferable to invest in systems solutions that would allow accounting on an individual contract basis.

The practical expedient in ASC 606-10-10-4 is available only if it is *reasonably expected* that the financial statement effects of applying ASC 606 to a portfolio of contracts would not differ materially from the effects of applying ASC 606 to the individual contracts within that portfolio. Accordingly, it is possible for entities to prepare their consolidated financial statements by using a mixture of approaches because the resulting accounting effects are not reasonably expected to differ materially.

As discussed in Section 3.1.2.1 above, entities are required to apply the new revenue standard consistently to similar contracts. In light of this, a company that uses the portfolio approach to account for some of its contracts may wonder whether it is required to use the same approach to account for all of its contracts. The Q&A below indicates that there may be situations in which it is acceptable for an entity to apply the portfolio approach to some contracts and not apply it to others.

Q&A 3-3 Application of a Portfolio Approach to Part of a Customer Base

Entity A is a telecommunications company that has a large number of contracts with customers with similar characteristics. Entity A does not elect to use a portfolio approach specified in ASC 606-10-10-4 when accounting for revenue from those contracts; instead, it has developed specialized computer systems that enable it to recognize revenue on a contract-by-contract basis.

At a later date, A acquires Entity B, which operates in the same jurisdiction as A and also has a large number of contracts with customers with characteristics that are similar to those of A. Entity B has previously elected to use a portfolio approach under ASC 606-10-10-4 when accounting for revenue from those contracts and does not have computer systems that would enable it to recognize revenue on a contract-by-contract basis.

Question

In its consolidated financial statements, can A use a portfolio approach only for contracts with B's customers?

Answer

Yes. Entity A can use a portfolio approach to account for B's contracts with customers as long as A reasonably expects that the use of such approach would not differ materially from applying ASC 606 on a contract-by-contract basis.

The requirement in ASC 606-10-10-3 to consistently apply ASC 606, including the use of any practical expedients, to contracts with similar characteristics and in similar circumstances does not override the overall concept of materiality.

Thinking It Through — Portfolio Practical Expedient Versus a Portfolio of Data Used in Making an Estimate

A question was raised regarding the use of the portfolio approach when an entity applies the guidance on estimating and constraining variable consideration. Specifically, the TRG discussed at its July 13, 2015, meeting whether an entity is using the portfolio practical expedient when it evaluates evidence from other similar contracts in applying the expected value method of estimating variable consideration. The TRG concluded that an entity's use of a portfolio of data to establish an estimate is not the same process as using the portfolio expedient in ASC 606-10-10-4. See Section 6.2.2 for the TRG's conclusion and Chapter 20 for insight into how this approach should be considered in an entity's implementation of the new revenue standard.

3.2 Scope

3.2.1 In General

ASC 606-10

Entities

15-1 The guidance in this Subtopic applies to all entities.

Transactions

15-2 An entity shall apply the guidance in this Topic to all contracts with customers, except the following:

a. Lease contracts within the scope of Topic 840, Leases {Topic 842, Leases}.
b. Insurance contracts within the scope of Topic 944, Financial Services — Insurance.
c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:
   1. Topic 310, Receivables
   2. Topic 320, Investments — Debt and Equity Securities
   {2a. Topic 321, Investments — Equity Securities}
   3. Topic 323, Investments — Equity Method and Joint Ventures
   4. Topic 325, Investments — Other
   5. Topic 405, Liabilities
   6. Topic 470, Debt
   7. Topic 815, Derivatives and Hedging
   8. Topic 825, Financial Instruments
   9. Topic 860, Transfers and Servicing.
d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.
e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Topic would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis. Topic 845 on nonmonetary transactions may apply to nonmonetary exchanges that are not within the scope of this Topic.

As outlined above in the objectives, the decision to establish new guidance on revenue recognition was made for multiple reasons. One of those reasons is stated in ASU 2014-09 as follows:

> Previous revenue recognition guidance in U.S. GAAP comprised broad revenue recognition concepts together with numerous revenue requirements for particular industries or transactions, which sometimes resulted in different accounting for economically similar transactions.

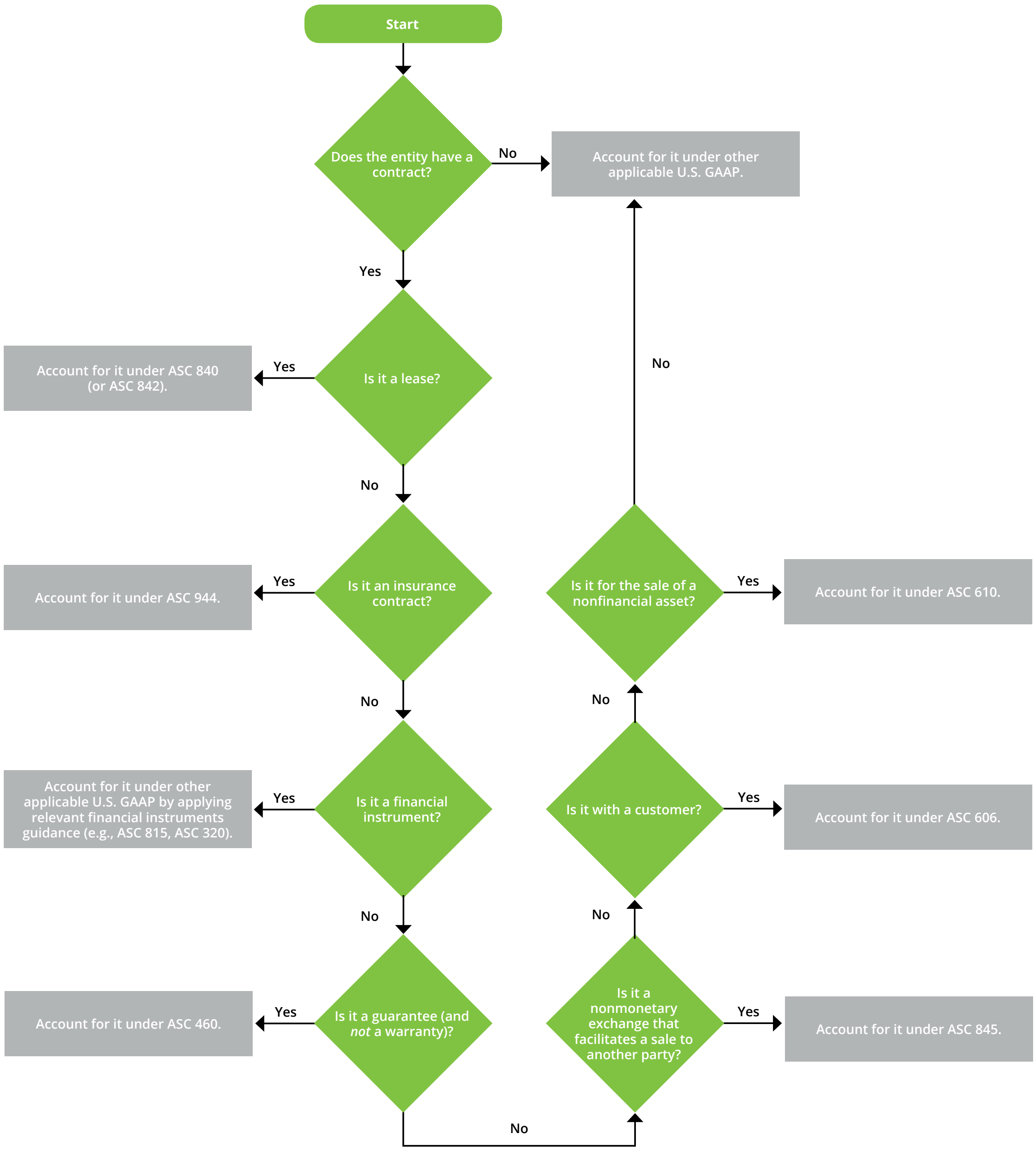
Therefore, a key goal of the FASB when creating the new guidance was to improve comparability of similar transactions across industries for financial statement users. That is, the comprehensive revenue framework established in ASC 606 would require entities in disparate industries to evaluate the new guidance consistently.

Thinking It Through — Consistency in Application

Consistency in application of the revenue standard across industries has been discussed publicly to emphasize its importance. As noted in Deloitte's December 15, 2015, *Heads Up*, the staff in the SEC's Office of the Chief Accountant (OCA) reiterated at the 2015 AICPA Conference on Current SEC and PCAOB Developments that it is focused on consistent application of the guidance to similar fact patterns both within and across industries. Companies should compare their application of the standard with that of other companies, and the appropriate implementation resources should be made aware of differences. The primary resource is the TRG, and the then SEC Deputy Chief Accountant Wesley Bricker expressed support for its continuation and highlighted the benefit it provides in fostering comparability between registrants that file under U.S. GAAP and foreign private issuers that file under IFRSs. Since its creation, the TRG has provided a public forum for transparent discussion and education related to the new standard and has addressed more than 50 implementation questions. The 16 AICPA industry task forces also address implementation questions and will publish interpretive guidance that can be used as a resource to promote consistency among preparers. Companies can also contact the OCA for help in addressing implementation questions. In light of the emphasis this topic has received, companies are expected to work through issues they foresee with other companies and even elevate the issues higher than the industry level to increase comparability across industries. Refer to Chapter 19 for recent TRG, SEC, and AICPA developments related to the new revenue standard.

Generally speaking, the boards' comprehensive framework was intended to cover all revenue transactions across all industries and geographies. Therefore, the scope of the new revenue guidance is very broad and is governed by two key terms, contract and customer. Because of the standard's broad scope, any arrangement that qualifies as a "contract" with a "customer" as those terms are defined should be within the scope of the new guidance. However, during the development of the new revenue standard, the FASB acknowledged that it had already developed or was developing comprehensive guidance on certain types of revenue-generating transactions. Specifically, the Board already had or was improving the guidance on leases, financial instruments, and insurance. As a result, it was necessary for the scope exceptions in ASC 606-10-15-2 to be created. Accordingly, a revenue-generating transaction related to a contract with a customer would be outside the scope of the new revenue standard only if it is within the scope of one of these other models.

Since the new revenue standard focuses on *contracts* with customers, companies might naturally think that their scope assessment should be performed at the contract level. However, it is important to remember that a contract can be made up of different components (or separate promises). Accordingly, companies should determine whether contracts include revenue and nonrevenue elements. See Section 3.2.5 for further details.



The new revenue standard includes implementation guidance on agreements containing a requirement or option to buy back a good sold to a customer ("repurchase agreements"). When a company has entered into a contract that includes such an obligation or right, it must assess whether control of the product has been transferred to the customer, as discussed in paragraph BC423 of ASU 2014-09. In many circumstances, if these features are present, control of the product is not transferred to the customer and the contract is treated as either a lease or a financing (i.e., the contract is not accounted for in accordance with ASC 606). The assessment of whether control is transferred to a customer (i.e., the entity satisfies its performance obligation) is outlined in step 5. For further discussion of transfer of control, including repurchase agreements, see Chapter 8.

It might appear that the scope of IFRS 15 is different from that of ASC 606 because the explicit scope exclusion for guarantees in ASC 606-10-15-2(d) is not included in IFRS 15. However, the inclusion of financial guarantees within the scope of the IASB's financial instruments standards (IFRS 9 and IAS 39) made it unnecessary to provide a separate scope exclusion in IFRS 15 for guarantees since such an exclusion would be redundant with the financial instruments exclusion in IFRS 15.

The Q&As below can help in the determination of whether a contract is within the scope of ASC 606.

Q&A 3-4 Performance Guarantees

ASC 606 specifically excludes from its scope contracts with customers that are guarantees (other than product or service warranties) within the scope of ASC 460.

Question

Are performance guarantees considered to be within the scope of ASC 460 and therefore not accounted for under ASC 606?

Answer

No. Typically, a performance guarantee would not be within the scope of ASC 460. Specifically, ASC 460-10-15-7(i) states that a guarantee or indemnification of an entity's own future performance is not within the scope of ASC 460.

For example, suppose that an entity has a contract with a customer to operate a call center. The contract includes a service level agreement guaranteeing that the average service call response time will be less than five minutes. If the call center does not meet the five-minute average wait time, the entity will have to pay the customer $1 million. This service level guarantee would not be within the scope of ASC 460. Therefore, the obligation to operate the call center would be accounted for as a performance obligation within the scope of ASC 606, and the potential payment of $1 million to the customer would be treated as variable consideration.

Q&A 3-5 Profit Margin Guarantees

As noted in Q&A 3-4 above, ASC 606 specifically excludes from its scope contracts with customers that are guarantees (other than product or service warranties) within the scope of ASC 460.

Question

Are profit margin guarantees considered to be within the scope of ASC 460 and therefore not accounted for under ASC 606?

Answer

No. By definition, profit margin guarantees typically do not contain a guarantee within the scope of ASC 460 because they qualify for scope exceptions under ASC 460-10-15-7 — specifically, ASC 460-10-15-7(e) (vendor rebates by the guarantor based on either the sales revenues of, or the number of units sold by, the guaranteed party) and ASC 460-10-15-7(g) (guarantees that prevent the guarantor from being able to recognize in earnings the profit from a sale transaction). Therefore, profit margin guarantees should be accounted for as a form of variable consideration within the scope of ASC 606.

For example, suppose that a clothing manufacturer sells clothing to a retail store (the "retailer") under a contract that offers the retailer a refund of a portion of the contract's sales price at the end of each season (i.e., a profit margin guarantee) if the retailer has not met a minimum sales margin. The retailer takes title to the clothing, and title remains with the retailer. The profit margin guarantee is agreed to at the inception of the contract and is a fixed amount. This arrangement would not contain a guarantee within the scope of ASC 460. Therefore, the clothing manufacturer should account for the potential payment to the retailer as a form of variable consideration within the scope of ASC 606.

Q&A 3-6 Whether Contributions Are Within the Scope of ASC 606

Question

Are contributions within the scope of ASC 606?

Answer

No. The ASC master glossary defines a contribution as follows:

> An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Those characteristics distinguish contributions from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately equal value; from investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and from other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers. In a contribution transaction, the value, if any, returned to the resource provider is incidental to potential public benefits. In an exchange transaction, the potential public benefits are secondary to the potential proprietary benefits to the resource provider. The term *contribution revenue* is used to apply to transactions that are part of the entity's ongoing major or central activities (revenues), or are peripheral or incidental to the entity (gains). See also [the ASC master glossary's definition of an inherent contribution].

Therefore, a contribution, by definition, is a nonreciprocal transfer and differs from an exchange transaction (e.g., a reciprocal transfer in which an entity exchanges goods or services for consideration).

ASC 606 does not explicitly state that contributions are outside its scope (see ASC 606-10-15-2). However, as explained in paragraph BC28 of ASU 2014-09, ASC 606 only applies to a subset of revenue, specifically revenue from contracts with customers. Therefore, because these transactions are nonreciprocal transfers, the counterparty (e.g., a donor) in a contribution transaction would not meet the ASU's definition of a customer:

> A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities **in exchange for consideration**. [Emphasis added]

However, if a not-for-profit entity transfers a good or service for part or all of a contribution (i.e., a reciprocal transfer), such a reciprocal transfer should be accounted for under ASC 606.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 3-7 Whether an Entity Can Recognize Revenue From a Nonmonetary Transaction Between Entities in the Same Line of Business That Is Excluded From the Scope of ASC 606

Question

Can an entity recognize revenue from a nonmonetary transaction that is subject to the scope exception in ASC 606-10-15-2(e) related to nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers (e.g., a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis)?

Answer

No. An entity is not permitted to recognize revenue resulting from such a transaction. As explained in paragraphs BC58 and BC59 of ASU 2014-09, since the party exchanging inventory with the entity in a transaction of this nature meets the definition of a customer, the entity might recognize revenue once for the exchange of inventory and do so again for the sale of inventory to the end customer in the absence of the specific scope exclusion. The FASB and IASB concluded that this outcome would be inappropriate because (1) it would gross up revenues and expenses and thereby make it difficult for financial statement users to assess the entity's performance and gross margins and (2) the counterparty in such an exchange transaction could be viewed as acting as a supplier rather than as a customer.

TRG Update — Whether Fixed-Odds Wagering Contracts Are Revenue or Derivative Transactions

Fixed-odds wagers are wagers placed by bettors (i.e., customers) who typically know the odds of winning in gaming activities[2] at the time the bets are placed with gaming industry entities. Under current U.S. GAAP, industry-specific guidance in ASC 924-605 indicates that such transactions are generally recognized as revenue when the wager is settled. However, when the new revenue standard becomes effective, that standard will eliminate the guidance in ASC 924-605 and will not apply to contracts accounted for as derivatives under ASC 815. In addition, stakeholders have referred to an issue discussed by the International Financial Reporting Interpretations Committee (IFRIC) in 2007, regarding which the IFRIC concluded that fixed-odds wagering contracts should be accounted for as derivatives under IAS 39 (or IFRS 9, if an entity is required to adopt it). Partly because of the upcoming elimination of ASC 924-605 and partly because of the 2007 IFRIC interpretation, stakeholders reporting under U.S. GAAP have questioned whether fixed-odds wagering contracts should be accounted for as revenue transactions (i.e., when or

[2] Common gaming activities include table games, slot machines, keno, bingo, and sports and race betting.

as control is transferred in accordance with the new revenue standard) or as derivatives (i.e., adjusted to fair value through net income each reporting period).

In November 2015, the FASB staff noted its belief that the FASB did not intend to change how entities reporting under U.S. GAAP would account for fixed-odds wagers upon adoption of the new revenue standard. That is, the FASB staff believes that the Board intends for entities reporting under U.S. GAAP to continue accounting for fixed-odds wagering contracts as revenue transactions. On the other hand, the FASB staff further indicated in TRG Agenda Paper 47 that "if fixed odds wagering contracts were excluded from the scope of the new revenue standard, then those arrangements likely would be accounted for as derivatives."

Many TRG members in the United States did not object to the FASB staff's view that entities should continue to account for fixed-odds wagering contracts as revenue transactions after the new revenue standard becomes effective. However, TRG members expressed concern that the current wording in the new revenue standard does not support the staff's view. Accordingly, TRG members recommended that the Board either (1) clarify its intent through a technical correction to include such contracts within the scope of ASC 606 (by excluding them from the scope of ASC 815) or (2) evaluate further whether its objective was to require entities to account for these contracts under ASC 815.

Construction Ahead — Technical Correction Proposed

On May 18, 2016, the FASB issued a proposed ASU on technical corrections to the new revenue guidance, which would include in ASC 924 a derivatives guidance scope exception for fixed-odds wagering contracts by adding a new subtopic (ASC 924-815, *Entertainment — Casinos: Derivatives and Hedging*) that would clarify that such contracts are revenue contracts within the scope of ASC 606. Comments on this proposal were evaluated by the FASB on August 31, 2016, and a final ASU consistent with this proposal is expected. Stay tuned for future developments on this topic, and see Chapter 19 for further discussion.

3.2.2 Scope of Guidance on Contract Costs

Although the clear focus of the boards' project was to improve the recognition of revenue, the boards also decided to include new guidance on contract costs in the final revenue standard. Accordingly, ASU 2014-09, which added ASC 606, also added ASC 340-40 to provide such cost guidance. Specifically, ASC 340-40 contains guidance on how to account for two types of costs related to a contract with a customer:

- "Incremental costs of obtaining a contract with a customer."
- "Costs incurred in fulfilling a contract with a customer that are not in the scope of another Topic."

For details on accounting for these types of costs, see Chapter 12.

The direct linkage between ASC 606 and ASC 340-40 resides in the following paragraph from the Codification:

> **ASC 606-10**
>
> **15-5** Subtopic 340-40 on other assets and deferred costs from contracts with customers includes guidance on accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfill a contract with a customer if those costs are not within the scope of another Topic (see Subtopic 340-40). An entity shall apply that guidance only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of the guidance in this Topic.

The Q&A below discusses the application of the portfolio approach to contract costs.

Q&A 3-8 Using the Portfolio Approach for Contract Costs

The guidance in ASC 340-40 was developed contemporaneously with that in ASC 606. ASC 340-40-05-1 expressly indicates that ASC 340-40 is aligned with ASC 606, stating that "[t]his Subtopic provides accounting guidance for the following costs related to a contract with a customer within the scope of Topic 606 on revenue from contracts with customers."

ASC 606 is applied at the individual contract level (or to a combination of contracts accounted for under ASC 606-10-25-9). In addition, ASC 606-10-10-4 allows an entity to apply, as a practical expedient, the revenue recognition guidance to a portfolio of contracts rather than an individual contract. The practical expedient can only be used "if the entity reasonably expects that the effects on the financial statements of applying [the revenue recognition guidance] to the portfolio would not differ materially from applying [the revenue recognition guidance] to the individual contracts (or performance obligations) within that portfolio." In addition, ASC 606-10-10-3 states that an "entity shall apply this guidance, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances."

Question

Can an entity use the portfolio approach when accounting for contract costs recognized under ASC 340-40?

Answer

Yes. If an entity reasonably expects that contract costs recorded under a portfolio approach would not differ materially from contract costs that would be recorded individually, an entity may apply a portfolio approach to account for the costs. The entity would use judgment in determining the characteristics of the portfolio in a manner similar to its assessment of whether a portfolio satisfies the requirements in ASC 606-10-10-4.

In applying the portfolio approach, an entity should consider paragraph BC69 of ASU 2014-09, which states that the FASB and IASB "did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts." In determining the characteristics and composition of the portfolio, an entity should consider the nature and timing of costs incurred and the pattern of transferring control of the related good or service to the customer (e.g., amortization of the capitalized costs).

There is a slight difference between the manner in which cost guidance is provided under IFRSs and how it is provided under U.S. GAAP. The IASB included its cost guidance in IFRS 15 instead of issuing a separate standard. However, because of the construct of the FASB's Codification, the FASB could not include cost guidance in the Codification's revenue topic; as a result, the FASB created a new subtopic, ASC 340-40, to address the cost guidance.

3.2.3 Determining the Customer in a Contract

ASC 606-10

15-3 An entity shall apply the guidance in this Topic to a contract (other than a contract listed in paragraph 606-10-15-2) only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

As noted in the Basis for Conclusions of ASU 2014-09, the FASB defined the term "customer" in the glossary of the new revenue standard to help companies understand and establish which transactions are within the standard's scope. For the purposes of ASC 606, a customer is a "party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." Despite some requests for further clarification, the Board purposefully did not define what constitutes "ordinary activities." In part, this decision was a compromise since the FASB's and IASB's respective conceptual frameworks differ slightly from each other in the words used to define revenue. Specifically, the IASB's Conceptual Framework description of revenue refers to the "ordinary activities of an entity," and the FASB's Concepts Statements describe revenue in terms of the entity's "ongoing major or central operations."[3] As discussed in paragraphs BC29 and BC53 of ASU 2014-09, the boards did not reconsider those definitions as part of the development of the new revenue standard.

Thinking It Through — Ordinary Activities Versus Ongoing Major or Central Operations

While the boards compromised on the definition of a customer, they did not change their respective definitions of revenue, which differ from each other in IFRS 15 and ASC 606. However, despite the difference in wording between "ordinary activities" and "ongoing major or central operations," we do not expect substantial differences between the two definitions. In addition, we would expect that the same transactions previously classified as revenue under legacy U.S. GAAP will also be presented as revenue (i.e., contracts with customers) under ASC 606.

There is separate guidance on transactions that do not meet the definition of revenue (i.e., the counterparty to the contract is not a customer). Typically, transactions not occurring with a customer may be one-off or infrequent transactions, such as the sale of a piece of equipment or the sale of a corporate headquarters building. For those instances, the FASB created a new subtopic, ASC 610-20, which is further discussed in Chapter 17.

[3] The concept of ordinary activities is derived from the definition of revenue in FASB Concepts Statement 6, which states that revenues "are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

3.2.4 Collaborative Arrangements

The Basis for Conclusions of ASU 2014-09 also explains that the relationship between a customer and a vendor varies from industry to industry and that companies will therefore have to consider their own facts and circumstances to determine who is a customer in an arrangement. For many contracts, this will not be very difficult to determine; however, paragraph BC54 of ASU 2014-09 provides the following examples of arrangements in which the facts and circumstances would have to be assessed:

> a. Collaborative research and development efforts between biotechnology and pharmaceutical entities or similar arrangements in the aerospace and defense, technology, and healthcare industries, or in higher education.
>
> b. Arrangements in the oil and gas industry in which partners in an offshore oil and gas field may make payments to each other to settle any differences between their proportionate entitlements to production volumes from the field during a reporting period.
>
> c. Arrangements in the not-for-profit industry in which an entity receives grants and sponsorship for research activity and the grantor or sponsor may specify how any output from the research activity will be used.

The example below illustrates how an entity would determine whether an arrangement is a collaborative arrangement and, if so, whether it should be accounted for under ASC 606.

Example 3-1

Biotech B and Pharma P enter into an agreement to research, develop, and commercialize drug X. Biotech B will perform the research and development, and Pharma P will commercialize the drug. Both parties agree to participate equally in all activities that result from the research, development, and commercialization. The reporting entity concludes that a collaborative arrangement exists because both parties are active participants and have agreed to share in the risks and rewards.

Despite this conclusion, however, there still could be an entity-customer relationship as a result of other contracts between the two companies. If such a relationship exists, those parts of the contract that are related to the entity-customer relationship should be accounted for under ASC 606.

Thinking It Through — Applicability of ASC 606 and ASC 808 to Collaborative Arrangements

ASC 606 does not change the guidance in ASC 808 on the income statement presentation, classification, and disclosures applicable to collaborative arrangements within the scope of the new revenue standard. It is important to understand that a contract could be within the scope of both the new revenue standard and the guidance on collaborative agreements, as indicated in paragraph BC55 of ASU 2014-09:

> The Boards noted that a contract with a collaborator or a partner (for example, a joint arrangement as defined in IFRS 11, *Joint Arrangements*, or a collaborative arrangement within the scope of Topic 808, Collaborative Arrangements) also could be within the scope of Topic 606 if that collaborator or partner meets the definition of a customer for some or all of the terms of the arrangement.

This is important because companies may have to assess the scope of both ASC 606 and ASC 808 for these types of arrangements. In addition, the ASU's Basis for Conclusions does not preclude companies from analogizing to the guidance in ASC 606 when accounting for collaborative arrangement transactions within the scope of ASC 808.

3.2.5 Contracts That Include Both Revenue and Nonrevenue Elements

ASC 606-10

15-4 A contract with a customer may be partially within the scope of this Topic and partially within the scope of other Topics listed in paragraph 606-10-15-2.

a. If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics and shall apply paragraphs 606-10-32-28 through 32-41 to allocate the amount of the transaction price that remains (if any) to each performance obligation within the scope of this Topic and to any other parts of the contract identified by paragraph 606-10-15-4(b).

b. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply the guidance in this Topic to separate and/or initially measure the part (or parts) of the contract.

When a contract includes multiple performance obligations, or deliverables (see Chapter 5 for information about defining a performance obligation), some of which are within the scope of other standards, any separation and initial measurement requirements of the other standards are applied first and the deliverables within the scope of the revenue model are ascribed any residual amount. If there are no separation or initial measurement requirements in those other standards, the requirements in ASC 606 are applied. That is, the guidance in ASC 606 is the default guidance to be used if there is no other relevant guidance.

For example, consider a company that enters into a single contract to lease a boat to a customer and provide cleaning services for that boat. Assume that the company assesses the promises in the contract and determines that (1) the lease of the boat is within the scope of the guidance on leases and (2) the cleaning services are within the scope of ASC 606. Further, assume that the company has adopted both the new revenue standard and the new leases standard. In accordance with ASC 606, the company would first look to the other guidance (the leases standard, in this situation) for guidance on how to allocate the consideration from the contract; if the other standard did not have allocation guidance, the company would apply the allocation guidance in ASC 606. In this situation, the leases standard says to apply the allocation guidance in ASC 606. Therefore, the company would use the new revenue standard's guidance to identify the performance obligations and allocate consideration between the revenue and nonrevenue (i.e., lease) components.

Construction Ahead — Insurance Contracts

Stakeholders have raised questions specific to the insurance industry about insurance companies with contracts that include both insurance and revenue elements (e.g., a high-deductible insurance policy with a claims processing service).

To address this concern, the FASB has proposed a technical correction (in its proposed ASU issued on May 18, 2016) that would modify ASC 606-10-15-2 as follows (added text is underlined, and deleted text is ~~struck out~~):

606-10-15-2 An entity shall apply the guidance in this Topic to all contracts with customers, except the following:

a. [Omitted]

b. ~~Insurance contracts~~ Contracts within the scope of Topic 944, Financial Services — Insurance.

c. [Omitted]

d. [Omitted]

e. [Omitted]

While this proposed technical correction would help address the issues raised, it would not resolve all questions. For further details about questions and recent developments related to this topic, refer to the discussion in Chapter 19 and stay tuned for future updates through the work of the AICPA insurance industry revenue working group.

3.2.6 Other Contracts That Pose Scope Challenges

Insurance contracts are not the only type of contracts that pose scope challenges. Entities will need to use judgment to determine whether the performance obligations in contracts meet one of the scope exceptions of the new revenue standard. The Q&A below illustrates how such a determination would be made.

Q&A 3-9 Accounting for Lapse of Warrants

An entity has issued warrants (options issued on the entity's own shares) for cash. These warrants meet the definition of equity instruments under ASC 815-40 and, accordingly, the amount received for issuing them was credited to equity. The warrants lapse unexercised.

Question

Should revenue be recognized when the warrants lapse unexercised?

Answer

No. The definition of comprehensive income (which encompasses both revenue and gains in accordance with the conceptual framework) excludes contributions from equity participants. The issuance of warrants is a transaction with owners (equity participants). The fact that an equity participant no longer has an equity claim on the assets of the entity does not convert the equity contribution into income. Amounts for warrants classified as equity instruments may be transferred to another account within equity (e.g., contributed surplus) as of the date the warrants expire.

TRG Update — Management Fees of Asset Managers

Compensation for asset managers commonly consists of both management fees (usually a percentage of assets under management) and incentive-based fees (i.e., fees based on the extent to which a fund's performance exceeds predetermined thresholds). Often, private-equity or real estate fund managers (who may be the general partner and have a small ownership percentage in the fund) will receive incentive-based fees by way of an allocation of capital from a fund's limited partnership interests (commonly referred to as "carried interests").

While Example 25 in the new revenue standard contains implementation guidance that demonstrates how to apply the variable constraint to an asset management contract, the example does not specify "whether the example applies to equity-based arrangements in which the asset manager is compensated for performance-based fees via an equity interest (that is, incentive-based capital allocations such as carried interest)."[4] Consequently, the following views have been expressed by stakeholders on whether carried interests are within the scope of the new revenue standard:

- *View A* — Carried interests are within the scope of the new revenue standard.
- *View B* — Carried interests are outside the scope of the new revenue standard.
- *View C* — An entity's accounting for carried interests may vary in accordance with the nature and substance of the arrangement.

Proponents of View A believe that carried interests are revenue transactions and analogize such interests to performance bonuses in contracts with customers in other industries (i.e., they believe that the purpose of carried interest arrangements and other similar arrangements is to compensate asset managers for their services). Accordingly, under View A, carried interests would be included in the transaction price subject to the constraint guidance on variable consideration. (See Chapter 6 for further discussion about estimating and constraining estimates of variable consideration.) Further, entities would be required to disclose additional information about these contracts in accordance with ASC 606-10-50.

Conversely, supporters of View B believe that "the arrangements should be accounted for as an ownership interest in accordance with other GAAP"[5] because an asset manager's investment in a limited partnership may meet the definition of financial assets or financial instruments, which are outside the scope of ASC 606. Proponents of View C believe that because these arrangements vary, entities would need to apply significant judgment in evaluating their nature and substance to determine the appropriate accounting.

The FASB staff supported View A because it believes that:

- Example 25 is evidence that the Board intended asset management service contracts, including those with incentive- or performance-based fees, to be within the scope of ASC 606.
- Carried interests are designed to compensate an asset manager for its services (i.e., in managing and investing in the fund).
- The Board confirmed that carried interests are more akin to services than to an ownership interest when it excluded performance-based fees from an entity's consolidation analysis (i.e., in determining whether the entity is the primary beneficiary of a variable interest entity) during its deliberations of ASU 2015-02.

[4] Quoted from paragraph 12 of TRG Agenda Paper 50.
[5] Quoted from paragraph 23 of TRG Agenda Paper 50.

During the TRG meeting in April 2016, after significant discussion, the TRG did not reach general agreement on whether carried interests in asset management arrangements are within the scope of ASC 606 and thus subject to the new revenue standard's variable constraint guidance. The Board reiterated that its intention was to include these arrangements within the scope of ASC 606 because the Board viewed these incentive-based fees as compensation for services provided (i.e., part of revenue transactions). Many TRG members agreed that the arrangements are within the scope of ASC 606.

However, some TRG members expressed an alternative view that a carried interest could be regarded as an equity arrangement because it is, in form, an interest in the entity. As a result of this view, those TRG members indicated that if the arrangements are considered equity interests outside the scope of ASC 606, questions could arise in a consolidation analysis — specifically, questions related to whether the asset managers should consolidate the funds.

The SEC staff's view is characterized in the meeting minutes (TRG Agenda Paper 55) as follows:

> The SEC staff observer indicated that he anticipates the SEC staff would accept an application of [ASC] 606 for those arrangements. However, the observer noted that there may be a basis for following an ownership model. If an entity were to apply an ownership model, then the SEC staff would expect the full application of the ownership model, including an analysis of the consolidation model under [ASC] 810, the equity method of accounting under [ASC] 323, or other relevant guidance[.]

We believe that an SEC registrant contemplating the ownership model view under ASC 323 should consider preclearing that treatment with the OCA.

The minutes of the TRG meeting suggest that the FASB staff does not recommend that the Board undertake standard-setting activity with respect to this topic.

TRG Update — Scope Considerations for Financial Institutions

The new revenue standard excludes transactions from its scope that are accounted for under other ASC topics, including those within the scope of ASC 405 (liabilities), ASC 460 (guarantees), ASC 815 (derivatives and hedging), and ASC 860 (transfers and servicing). The new standard also notes that entities should apply ASC 606 to contracts with a customer or portions thereof if other ASC topics do not contain guidance on separation or initial measurement. To determine which guidance applies to the fees associated with certain common financial institution transactions, stakeholders have asked the FASB to clarify whether (1) mortgage servicing rights[6] should be accounted for under ASC 606 or ASC 860, (2) deposit-related fees[7] should be accounted for under ASC 405, and (3) fees from financial guarantees[8] should be accounted for under ASC 460 or ASC 815. These matters were discussed at the April 2016 TRG meeting, and the TRG generally agreed with the FASB staff's analysis and conclusions.

[6] After originating a loan (or selling an originated loan but retaining rights to service the loan), a financial institution may perform services that include communicating with the borrower; collecting payments for interest, principal, and other escrow amounts; and performing recordkeeping activities.

[7] Deposit-related fees are those that a financial institution charges to a customer for amounts on deposit with the financial institution. Fees may be charged to give customers access to their funds and to cover other activities, including recordkeeping and reporting. In addition, fees may be transaction-based (such as fees to withdraw funds through an automated teller machine) or may not be transaction-based (such as account maintenance fees).

[8] Fees charged by a financial institution to a borrower on a loan, for example, in return for the financial institution's acting as a third-party guarantor on the borrower's debt.

Mortgage Servicing Rights

The FASB staff noted that assets and liabilities associated with mortgage servicing rights traditionally have been accounted for under ASC 860 and that such practice will not change under the new revenue standard. The staff believes that servicing arrangements that are within the scope of ASC 860 are not within the scope of ASC 606 and that ASC 860 addresses both the initial recognition and subsequent measurement of mortgage servicing assets and liabilities. In the staff's view, since the subsequent measurement of the mortgage servicing assets and liabilities depends on the cash flows associated with the mortgage servicing rights, ASC 860 should be used to account for such cash flows.[9]

Deposit-Related Fees

The FASB staff noted that entities would account for revenue from deposit-related fees in accordance with ASC 606 after they adopt the new standard. Financial institutions would continue to (1) record liabilities for customer deposits because the deposits meet the definition of a liability and (2) account for customer deposits in accordance with ASC 405. However, because ASC 405 does not contain specific guidance on how to account for deposit fees, financial institutions should apply ASC 606 for deposit-related fees (i.e., in manner similar to the application of existing SEC revenue guidance by some financial institutions to account for deposit-related fees). The FASB staff suggested that implementation concerns raised by some stakeholders could be alleviated by careful analysis of the contract terms between the financial institution and the customer. Because customers generally have the right to cancel their depository arrangement at any time, the FASB staff believes that most contracts would be short term (e.g., day to day or minute to minute). As a result, revenue recognition patterns would be similar regardless of the number of performance obligations identified, and any changes to current practice would most likely be insignificant.

Fees Related to Financial Guarantees

The FASB staff noted that fees related to financial guarantees should be accounted for in accordance with either ASC 460 or ASC 815. The basis for the staff's view is partly due to its belief that "the fee would not be received unless the guarantee was made, and the guarantee liability is typically reduced (by a credit to earnings) as the guarantor is released from the risk under the guarantee."[10] Further, the staff believes that ASC 460 or ASC 815 provides a framework that addresses both initial recognition and subsequent measurement of the guarantee. In addition, the staff cited paragraph BC61 of ASU 2014-09 as further evidence of the Board's intent to exclude guarantees from the scope of ASC 606. The staff also noted that it may suggest technical corrections to the Board to clarify the scope for fees from financial guarantees in ASC 942-825-50-2 and ASC 310-10-60-4.

See TRG Agenda Paper 52 for additional information.

Construction Ahead — Financial Guarantees

At the FASB's meeting on August 31, 2016, the FASB staff proposed making the technical correction discussed above. See Chapter 19 for further details.

[9] Paragraph 11 of TRG Agenda Paper 52 notes that some entities believe that there is a close link between ASC 860's asset and liability remeasurement requirements and the collection of servicing fees (which gives rise to mortgage servicing income).

[10] Quoted from paragraph 61 of TRG Agenda Paper 52.

TRG Update — Credit Card Fees and ASC 606

Stakeholders have asked whether the guidance in ASC 310 or the guidance in ASC 606 should be applied to the rights and obligations under a credit card issuing bank's contract as well as the corresponding reward program (i.e., a loyalty program). The guidance that is applied would affect the timing of revenue recognition.

ASC 310-20-35-5 states:

> Fees deferred in accordance with paragraph 310-20-25-15 shall be recognized on a straight-line basis over the period the fee entitles the cardholder to use the card. This accounting shall also apply to other similar card arrangements that involve an extension of credit by the card issuer.

In contrast, if it is determined that some or all of the arrangement is within the scope of ASC 606, an assessment must be made to determine whether the rewards the customer earns are a material right and therefore a performance obligation. If the rewards are a performance obligation, the revenue allocated to the performance obligation cannot be recognized until the rewards are redeemed for goods or services under the reward program. This period could be longer than the period over which revenue would be recognized under ASC 310. Under current U.S. GAAP, credit card arrangements are typically accounted for under ASC 310.

In discussing the issue, TRG members in the United States generally agreed with the following observations and conclusions of the FASB staff:

- The FASB staff noted that all credit card fees are currently accounted for under ASC 310 because they are related to credit lending activities (i.e., akin to loan origination fees). The staff also noted that the new revenue standard does not include consequential amendments to ASC 310. Accordingly, the staff believed that entities would continue to account for services exchanged for credit card fees under ASC 310 rather than ASC 606. However, the staff noted that as an anti-abuse measure, entities need to assess whether credit card fees and services should be accounted for under ASC 606 when the issuance of a credit card appears incidental to the arrangement (e.g., when a card is issued in connection with the transfer of (1) an automobile or (2) asset management services).
- The FASB staff indicated that if an entity concludes that the credit card arrangement is within the scope of ASC 310, the associated reward program would also be within the scope of ASC 310.

TRG members also noted that outcomes under U.S. GAAP may differ from those under IFRSs because of differences between ASC 310 and IFRS 9.

Q&A 3-10 Scope of ASC 606: Bank-Issued Credit Card Arrangements

Credit card arrangements are typically accounted for under ASC 310 because they are related to credit lending activities. ASC 606-10-15-2 indicates that financial instruments within the scope of other Codification topics, including ASC 310, are excluded from the scope of the revenue standard. However, ASC 606-10-15-4 notes that a contract may be partially within the scope of ASC 606 if other Codification topics "do not specify how to separate and/or initially measure one or more parts of the contract."

Question

Are the rights and obligations under a contract between a credit card–issuing bank and the cardholder (including, for example, reward programs) within the scope of ASC 606?

Answer

Generally, no. Because ASC 606 does not include consequential amendments to ASC 310, entities would most likely continue to account for credit card arrangements under ASC 310 rather than ASC 606. Such arrangements would include any initial or period fees charged to the card holder. However, entities will need to assess whether credit card fees and services should be accounted for under ASC 606 when the issuance of a credit card appears incidental to the arrangement (e.g., when a card is issued in connection with the transfer of (1) an automobile or (2) asset management services).

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Chapter 4 — Step 1: Identify the Contract

For contracts within the scope of ASC 606, the first step of the new revenue standard is to determine whether a contract exists, for accounting purposes, between an entity and its customer. The criteria that need to be in place to establish that a contract exists are intended to demonstrate that there is a valid and genuine transaction between an entity and its customer and that the parties to the contract have enforceable rights and obligations that will have true economic consequences. If, at contract inception, the criteria in ASC 606-10-25-1 are met, the contract would be accounted for under the remaining provisions of the standard. Because the rest of the provisions of the new standard rely on a careful analysis of the enforceable rights and obligations under the contract, if any of the five criteria required to establish a contract for accounting purposes are not met, the rest of the revenue recognition model cannot be applied. In these circumstances, any consideration received from the customer would be recognized as a liability (see Section 4.5), and revenue can only be recognized once (1) the contract existence criteria are met (assuming that the rest of the revenue recognition model supports the recognition of revenue) or (2) the consideration received is nonrefundable and one or more of the following have occurred:

- All of the performance obligations in the contract have been satisfied and substantially all of the promised consideration has been received.
- The contract has been terminated or canceled.
- The entity has transferred control of the goods or services to which the consideration received is related and has stopped transferring (and has no obligation to transfer) additional goods or services to the customer.

Changing Lanes — Effect of Not Meeting the Contract Existence Criteria

Not meeting the contract existence criteria could result in revenue recognition profiles that are substantially different from those under current U.S. GAAP, especially for entities that record revenue on a cash basis because collectibility of amounts is not reasonably assured. For additional discussion, see Section 4.2.

The new revenue standard also provides guidance on when two or more contracts should be combined and evaluated as a single contract for determining revenue recognition (see Section 4.6) as well as the accounting for contract modifications (see Chapter 9).

4.1 Identifying a Contract With a Customer

An important step in the new revenue standard is determining when an agreement with a customer represents a contract for accounting purposes. A contract creates enforceable rights and obligations between two or more parties. Enforceability of the rights and obligations is a matter of law. An agreement does not need to be in writing to constitute a contract. A contract may exist if parties orally agree to an arrangement's terms. Alternatively, a contract could be implied through customary business practices if those practices create enforceable rights and obligations.

ASC 606-10

25-2 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

Because the rest of the revenue model cannot be applied until a valid contract is in place, it is important to determine when enforceable rights and obligations are created between two or more parties. Varying contracting practices can sometimes make this determination difficult. Even if two parties are in basic agreement about the main terms of a contract, no contract would exist if the parties' rights and obligations under the contract are not legally enforceable. For example, as illustrated in the Q&A below, a question might arise about whether it is appropriate for an entity to apply the revenue recognition model in ASC 606 when it does not yet have a written sales agreement but such an agreement is being prepared.

Q&A 4-1 Written Sales Agreement Being Prepared but Not Yet Signed

Question

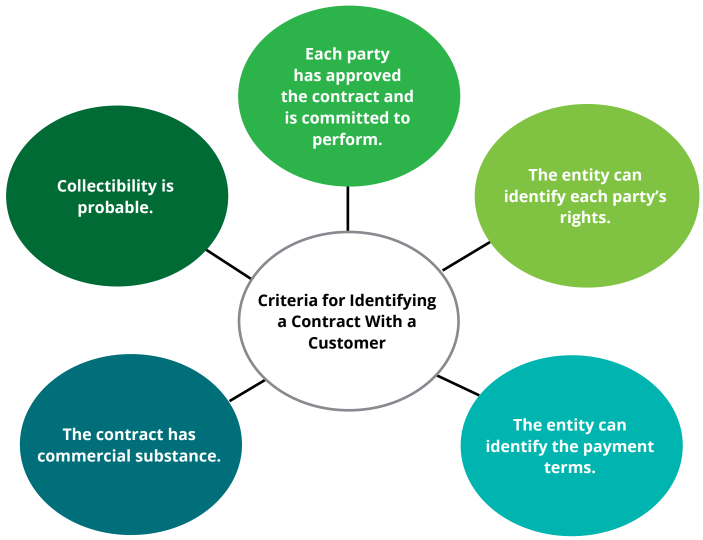
If an entity does not yet have a written sales agreement, but a written sales agreement is being prepared, is it appropriate for the entity to apply the revenue recognition model in ASC 606?

Answer

Not necessarily. An entity applies the revenue recognition model in ASC 606 when there is an agreement between two or more parties that creates enforceable rights and obligations. Whether the agreed terms are written, oral, or evidenced otherwise (e.g., by the entity's customary business practices), a contract exists if the agreement creates rights and obligations that are enforceable against the parties. Determining whether a contractual right or obligation is enforceable is a question of law, and the factors that determine enforceability may differ between jurisdictions. The best evidence of an enforceable agreement is a written contract, especially if the seller's standard practice is to use written contracts.

Although ASC 606 does not require a written contract as evidence of an agreement, a contract that is being prepared but has not yet been signed may be evidence that agreement has not yet been reached. Entities should use caution before recognizing revenue in such circumstances, because the apparent absence of a contractual understanding between the parties may make it unlikely that the conditions in ASC 606-10-25-1 have been met.

4.2 Criteria for Identifying a Contract With a Customer



As shown below, ASC 606-10-25-1 provides criteria that an entity should evaluate at contract inception to determine whether an arrangement should be accounted for under the new revenue standard.

ASC 606-10

25-1 An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

a. **The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.**
b. **The entity can identify each party's rights regarding the goods or services to be transferred.**
c. **The entity can identify the payment terms for the goods or services to be transferred.**
d. **The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).**
e. **It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).**

In many instances, the evaluation of the criteria in ASC 606-10-25-1 should be straightforward. However, certain arrangements will require careful evaluation to determine whether the contract creates enforceable rights and obligations between an entity and its customer.

Certain existing revenue standards are consistent with the principles in ASC 606-10-25-1, including those embodied in SAB Topic 13 and ASC 985-605 (formerly SOP 97-2), which require that (1) there is persuasive evidence of an arrangement and (2) collectibility is reasonably assured.[1] However the application of these principles differs under the new revenue standard. The Q&A below compares the requirements for a contract's existence under ASC 606 with those under ASC 605.

[1] ASC 985-605 (formerly SOP 97-2) uses the term "probable" as defined in ASC 450.

Q&A 4-2 Comparison of Requirements Under ASC 606 and ASC 605 for a Contract's Existence

Question

Is the guidance on identifying whether a contract exists under ASC 606 different from the requirements under ASC 605?

Answer

Yes. As outlined above, ASC 606 introduces new criteria; therefore, there may be differences between the assessment performed under ASC 606 to identify a contract with a customer and how an entity would determine what constitutes persuasive evidence of an arrangement under ASC 605. Although the guidance in ASC 606 may generally seem more stringent given the list of criteria that must be satisfied, changes in practice are expected to be infrequent and limited to certain industries (e.g., health care or software) or transactions.

The examples below illustrate some of the circumstances in which the analysis may be different under the new revenue standard.

Example 1

SAB Topic 13.A.2 — Persuasive Evidence of an Arrangement

In its response to Question 1 of SAB Topic 13.A.2, the SEC states that the existence of persuasive evidence of an arrangement would be determined on the basis of an entity's normal and customary business practices. In the scenario in Question 1, revenue was not able to be recognized because the requisite approval from the legal department of the customer was not obtained despite the presence of an oral agreement from the purchasing department. Under the new revenue standard, while customary business practices need to be considered, an entity may have legally enforceable rights and obligations before all requisite approvals have been obtained. An entity may be required to perform a careful legal analysis to determine whether the contract existence criteria have been met.

Example 2

ASC 985-605 — Persuasive Evidence of an Arrangement

"Persuasive evidence of an arrangement" is required under the guidance for software companies in ASC 985-605-25-15 through 25-17, which states that if "the vendor has a customary business practice of using written contracts, evidence of the arrangement is provided only by a contract signed by both parties." This guidance has often been strictly interpreted to require a signed contract in all instances (e.g., an e-mail supporting approval may not meet the criteria). As similarly discussed in Example 1 above, under the new revenue standard, determining whether the parties to a contract have enforceable rights and obligations is a matter of law. In some instances, the contract existence criteria may be met even if signatures from both parties have not been obtained. However, we believe that signed agreements provide the best evidence of enforceable rights and obligations.

Example 3

ASC 954-605 — Collectibility

In the health care industry, entities do not necessarily have to assess collectibility under existing industry-specific guidance when a patient arrives and needs treatment. ASC 954-605-25-3 states, "In general, gross service revenue is recorded in the accounting records on an accrual basis at the provider's established rates, regardless of whether the health care entity expects to collect that amount." In contrast, ASC 606 requires all entities to assess collectibility in step 1, which may result in a difference in when and in what amount revenue is being recognized.

Thinking It Through — Contract Existence Criteria Versus Persuasive Evidence of an Arrangement

Although the criteria for establishing a contract under the new revenue standard are slightly different from the requirement to demonstrate persuasive evidence of an arrangement under current U.S. GAAP, the analysis under the new revenue standard will often be the same as that under existing guidance. Many entities should be able to leverage existing processes and procedures to evaluate whether a valid and genuine transaction exists (i.e., whether the contract existence criteria are met). However, entities in certain industries may need to make changes to existing systems of internal controls to comply with the new revenue standard's requirements for determining whether a contract exists.

Sections 4.2.1 through 4.2.5.3 further discuss each of the five criteria required to establish a contract with a customer.

4.2.1 Each Party Has Approved the Contract and Is Committed to Perform

For a contract to be accounted for under the new revenue standard, the parties must approve the contract and be committed to perform their respective obligations.

A party may approve a contract in writing, orally, or through its customary business practices. If both parties to a contract do not approve the contract, it is unclear whether that contract creates enforceable rights and obligations that bind the parties to perform their respective obligations. Paragraph BC35 of ASU 2014-09 states that "the form of the contract does not, in and of itself, determine whether the parties have approved the contract." Entities will need to evaluate all relevant facts and circumstances, including their customary business practices, to determine whether both parties have approved the contract.

As noted above, each party must also be committed to perform under the contract. However, paragraph BC36 of ASU 2014-09 clarifies that each party will not always need to be committed to performing all of its obligations to meet this requirement. To illustrate, paragraph BC36 cites an example in which a customer is contractually required to make a minimum monthly purchase of goods provided by an entity. Despite the requirement, the customer does not always make the minimum monthly purchase and historically has not been forced by the entity to comply. In this example, the contractual requirement could still be met because the parties have demonstrated that they are "substantially committed to the contract."[2]

[2] Quoted from paragraph BC36 of ASU 2014-09.

ASC 606 does not apply to a wholly unperformed contract when each party has the unilateral ability to terminate the contract without compensating the other party. However, the standard applies when only one party has a right to terminate the contract. Accordingly, entities will need to carefully consider termination clauses when evaluating whether each party is committed to the contract. For further discussion, see Sections 4.3 and 4.7.

4.2.2 The Entity Can Identify Each Party's Rights

An entity must be able to identify each party's rights related to the promised goods or services in the contract. Without knowing each party's rights, an entity would not be able to identify its performance obligations and determine when control of the goods and services are transferred to the customer (i.e., when to recognize revenue). Parties to the contract have valid rights and obligations when both (1) the entity has a right to receive consideration from the customer in exchange for the transfer of goods or services and (2) the customer has a right to require the entity to perform (i.e., transfer goods or services).

4.2.3 The Entity Can Identify the Payment Terms

A contract must include payment terms for each of the promised goods and services in an arrangement for an entity to determine the transaction price. The payment terms do not need to be fixed, but the contract must contain enough information to allow an entity to reasonably estimate the consideration to which it will be entitled for transferring the goods and services to the customer. See Section 6.1 for more information on determining the transaction price and Section 6.2 for information about variable consideration.

4.2.4 The Contract Has Commercial Substance

For a contract to have commercial substance, the risk, timing, or amount of an entity's future cash flows must be expected to change as a result of the contract. That is, the transaction(s) between the parties should have economic consequences. Most business transactions will involve an entity's sale of goods or services in exchange for cash; therefore, an entity's future cash flows are expected to change as a result of the arrangement. Arrangements that include noncash consideration may require an entity to perform further analysis in evaluating whether the contract has commercial substance. The commercial substance requirement in the new revenue standard is consistent with the principles of ASC 845 for evaluating whether a nonmonetary exchange has commercial substance; however, the criterion needs to be evaluated for all contracts (not just those with nonmonetary consideration).

Thinking It Through — Round-Trip Transactions

Exchange transactions involving nonmonetary consideration often require careful analysis to determine the substance of the arrangement. For example, a round-trip transaction is an arrangement in which one company sells an item (e.g., goods, services, financial assets) to a customer, which in turn sells goods, services, or financial assets back to the initial seller. The substance of the transaction is critical to determining the appropriate accounting. The individual transactions in a round-trip transaction are often entered into in contemplation of one another and may lack commercial substance. That is, the entity's future cash flows are not expected to change as a result of the arrangement. If such a transaction is not accounted for properly, it can lead to artificial inflation of the revenues of each party to the contract.

Driving Discussion — Free Trial Period

Certain arrangements provide a customer with free goods or services at the onset of the contract. Stakeholders have questioned whether all of the criteria in ASC 606-10-25-1 are met during the free trial period. Specifically, they have asked whether the contract meets the commercial substance criterion (i.e., whether the risk, timing, or amount of an entity's future cash flows is expected to change) and whether each party has approved the contract and is committed to perform.

For example, suppose that an entity has a marketing program that offers a three-month "trial period" during which a customer can obtain free magazines. If the customer does not cancel at the end of three months, it will be charged the annual subscription fee of $12 per monthly magazine, or $144.

Because the parties to the contract are not committed to perform their respective obligations, no contract exists during the free trial period unless and until the customer "accepts" the offer. Once the customer accepts the offer and is committed to pay $144, a valid contract exists and the rest of the revenue recognition model can be applied.

Arrangements with trial periods have also raised questions about how an entity should recognize revenue once a contract exists. Specifically, questions have been raised about whether any of the transaction price should be allocated to the free goods or services. This concept is discussed in further detail in Section 8.9.2.

As noted above, the new revenue model cannot be applied (and no revenue can be recognized) until a contract exists for accounting purposes. However, entities sometimes commence activities under a specific anticipated contract with a customer (e.g., construction of an asset) before the parties have agreed to all of the contract terms or before the criteria for identifying the contract in ASC 606-10-25-1 have been satisfied. No revenue can be recognized during the precontract phase since the contract existence criteria have not been met. See Q&A 8-32 for a discussion of how to account for these types of arrangements once the contract existence criteria are met.

4.2.5 Collectibility Is Probable

ASC 606-10-25-1(e) requires an entity to evaluate whether it is probable[3] that substantially all of the consideration to which the entity will be entitled for goods or services transferred to the customer will be collected. This analysis is performed at contract inception and is not revisited unless there is a significant change in facts and circumstances (see Section 4.4). Such an evaluation should take into account only the customer's ability and intention to pay the consideration when it is due. All facts and circumstances should be considered in the evaluation of a customer's ability and intention to pay amounts due. Such facts and circumstances could include past experience with the customer, class of customer, and expectations about the customer's financial stability, as well as other factors.

4.2.5.1 Price Concessions

As part of determining whether a valid and genuine contract exists, an entity is required to evaluate whether it is probable that the entity will collect substantially all of the consideration to which it is entitled under the contract. However, the consideration to which an entity is ultimately entitled may be less than the price stated in the contract because the customer is offered a price concession. Price

[3] As noted in the table of differences between ASC 606 and IFRS 15 in Appendix A, the collectibility threshold under U.S. GAAP differs from that under IFRSs.

concessions are a form of variable consideration (see Section 6.2) and need to be analyzed when the transaction price is being determined (as part of step 3 of the new revenue model). However, as part of step 1, an entity would evaluate whether it is probable that the entity will collect the consideration to which it will be entitled for providing goods or services to a customer after considering any price concessions. This evaluation requires aspects of step 3 to be performed in conjunction with step 1. Differentiating between credit risk (i.e., the risk of collecting less consideration than the amount the entity legitimately expected to collect from the customer) and price concessions (i.e., entering into a contract with a customer with the expectation of accepting less than the contractual amount of consideration in exchange for goods or services) may be difficult. Entities will need to use significant judgment in determining whether they have provided an implicit price concession or have accepted a customer's credit risk. This is particularly true of entities in highly regulated industries, such as health care and consumer energy, which may be required by law to provide certain goods and services to their customers regardless of the customers' ability to pay. Because of the nature of these arrangements, entities will need to evaluate all of the relevant facts and circumstances of their arrangements to determine whether they have provided implicit price concessions or whether the anticipated receipt of less than the total contractual consideration represents credit risk.

The Q&A below discusses some price concession indicators.

Q&A 4-3 Price Concession Indicators

Question

When an entity assesses the variability between the contractually stated price and the amount it expects to collect, what are indicators that the entity has actually granted a price concession?

Answer

The determination of whether the entity has offered a price concession (variable consideration affecting the amount of revenue recognized) or assumed credit risk (may recognize expense as bad debt) will require judgment. The following indicators may suggest that the entity has offered a price concession:

- The entity has a customary business practice of providing discounts or accepting as payment less than the contractually stated price regardless of whether such a practice is explicitly stated at contract inception or specifically communicated or offered to the customer.
- The customer has a valid expectation that the entity will accept less than that contractually stated price. This could be due to customary business practices, published policies, or specific statements made by the entity.
- The entity transfers the goods or services to the customer, and continues to do so, even when historical experience indicates that it is not probable that the entity will collect the billed amount.
- Other facts and circumstances indicate that the customer intends to pay an amount that is less than the contractually stated price, and the entity nonetheless enters into a contract with the customer.
- The entity has a customary business practice of not performing a credit assessment before transferring goods or services to the customer (e.g., the entity is required by law or regulation to provide emergency medical services before assessing the customer's ability or intention to pay).

Examples 2 and 3 in ASC 606 illustrate how an entity would evaluate implicit price concessions when assessing whether the collectibility criterion is met.

ASC 606-10

Example 2 — Consideration Is Not the Stated Price — Implicit Price Concession

55-99 An entity sells 1,000 units of a prescription drug to a customer for promised consideration of $1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

55-100 When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraphs 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not $1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to $400,000.

55-101 The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect $400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of $400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the guidance in this Topic.

Example 3 — Implicit Price Concession

55-102 An entity, a hospital, provides medical services to an uninsured patient in the emergency room. The entity has not previously provided medical services to this patient but is required by law to provide medical services to all emergency room patients. Because of the patient's condition upon arrival at the hospital, the entity provides the services immediately and, therefore, before the entity can determine whether the patient is committed to perform its obligations under the contract in exchange for the medical services provided. Consequently, the contract does not meet the criteria in paragraph 606-10-25-1, and in accordance with paragraph 606-10-25-6, the entity will continue to assess its conclusion based on updated facts and circumstances.

55-103 After providing services, the entity obtains additional information about the patient including a review of the services provided, standard rates for such services, and the patient's ability and intention to pay the entity for the services provided. During the review, the entity notes its standard rate for the services provided in the emergency room is $10,000. The entity also reviews the patient's information and to be consistent with its policies designates the patient to a customer class based on the entity's assessment of the patient's ability and intention to pay. The entity determines that the services provided are not charity care based on the entity's internal policy and the patient's income level. In addition, the patient does not qualify for governmental subsidies.

55-104 Before reassessing whether the criteria in paragraph 606-10-25-1 have been met, the entity considers paragraphs 606-10-32-2 and 606-10-32-7(b). Although the standard rate for the services is $10,000 (which may be the amount invoiced to the patient), the entity expects to accept a lower amount of consideration in exchange for the services. Accordingly, the entity concludes that the transaction price is not $10,000 and, therefore, the promised consideration is variable. The entity reviews its historical cash collections from this customer class and other relevant information about the patient. The entity estimates the variable consideration and determines that it expects to be entitled to $1,000.

ASC 606-10 (continued)

55-105 In accordance with paragraph 606-10-25-1(e), the entity evaluates the patient's ability and intention to pay (that is, the credit risk of the patient). On the basis of its collection history from patients in this customer class, the entity concludes it is probable that the entity will collect $1,000 (which is the estimate of variable consideration). In addition, on the basis of an assessment of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 also are met. Consequently, the entity accounts for the contract with the patient in accordance with the guidance in this Topic.

4.2.5.2 Evaluating Credit Risk

The existence of the collectibility requirement does not eliminate credit risk in a contract with a customer. Not all differences between the contractually stated price and the amount ultimately collected by the entity will be due to explicit or implied concessions. In a manner similar to current practice, entities will continue to (1) assume collection risk and (2) incur bad debt.

The Q&A below discusses some indicators that an entity has incurred bad debt.

Q&A 4-4 Indicators of Bad Debt

Question

When an entity assesses the variability between the contractually stated price and the amount it expects to collect, what are indicators that this difference is due to bad debt?

Answer

The determination of whether the entity has offered a price concession (variable consideration affecting the amount of revenue recognized) or assumed credit risk (may recognize expense as bad debt) will require judgment. The following indicators may suggest that the entity has incurred a bad debt:

- The entity has the ability to stop transferring goods or services to the customer and has no obligation to transfer additional goods or services in the event of nonpayment for goods or services already transferred to the customer (e.g., in the event of nonpayment by a utility customer, the utility provider ceases to provide further services to the customer).
- The entity believes that it will collect the consideration due and intends to enforce the contract price, but it knowingly accepts the risk of default by the customer. For example, the entity is able to conclude that the criterion in ASC 606-10-25-1(e) is met, but it is aware of the customer's increased risk of bankruptcy and chooses to provide the contractually agreed-upon goods or services to the customer despite this fact.
- The customer's financial condition has deteriorated since contract inception.
- The entity has a pool of homogeneous customers that have similar credit profiles. Although it is expected that substantially all of the customers will be able to pay amounts when due, it is also expected that a small (not currently identifiable) number of customers may not be able to pay amounts when due.

The criterion in ASC 606-10-25-1(e) acts as a collectibility threshold and requires an entity to assess its customer's credit risk in determining whether a valid contract exists. The term "probable" is defined in the ASC 606 glossary as the "future event or events are likely to occur," which is consistent with the current U.S. GAAP definition of "probable."

Changing Lanes — Effect of Collection Risk

The principle of evaluating collectibility is generally consistent with SAB Topic 13, which requires collectibility to be "reasonably assured." We believe that the collectibility requirement of "reasonably assured" is substantially the same as "probable," and that the amended terminology is unlikely to change current practice in this respect. However, ASC 606 has fundamentally changed (1) when entities perform the collectibility assessment and (2) the impact of concluding that amounts due for goods or services that will be transferred to the customer are not probable of collection. Under current guidance, an entity assesses collectibility to determine whether it should recognize revenue and, if so, in what amount. However, under the new revenue standard, an entity evaluates collectibility in step 1 to determine whether a valid contract exists and whether the remaining steps in the revenue model can be applied. We expect this fundamental change to significantly affect entities that currently recognize revenue in a manner similar to the cash basis of accounting when collectibility is not reasonable assured.

4.2.5.3 Collectibility Assessment — Other Considerations

Paragraph BC46 of ASU 2014-09 notes that the FASB and IASB intended the collectibility assessment to be made only for consideration to which an entity would be entitled in exchange for the goods or services that will be transferred to the customer. That is, if the customer fails to pay for goods or services transferred and the entity reacts by not transferring any additional goods or services to the customer, only the consideration associated with the goods or services already transferred to the customer should be assessed for collectibility.

On May 9, 2016, the FASB issued ASU 2016-12,[4] which amends certain aspects of ASU 2014-09 to clarify the concept discussed in paragraph BC46. Specifically, ASU 2016-12 (1) further clarifies the objective of the collectibility threshold, (2) includes implementation guidance on how to evaluate circumstances in which credit risk is mitigated, and (3) adds guidance on when revenue should be recognized if a contract fails to meet the requirements in ASC 606-10-25-1 (see Section 4.5 below).

ASU 2016-12 adds the following implementation guidance to assist in the analysis of the collectibility threshold:

ASC 606-10

55-3A Paragraph 606-10-25-1(e) requires an entity to assess whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. The assessment, which is part of identifying whether there is a contract with a customer, is based on whether the customer has the ability and intention to pay the consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer. The objective of this assessment is to evaluate whether there is a substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue model in this Topic.

55-3B The collectibility assessment in paragraph 606-10-25-1(e) is partly a forward-looking assessment. It requires an entity to use judgment and consider all of the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity expects to transfer to the customer. The assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

[4] The IASB did not amend IFRS 15 to clarify the Board's intent with respect to collectibility. However, the FASB and IASB do not expect significant differences in application. See Appendix A for a summary of differences between IFRS 15 and ASC 606.

ASC 606-10 (continued)

55-3C When assessing whether a contract meets the criterion in paragraph 606-10-25-1(e), an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

a. Payment terms — In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.
b. The ability to stop transferring promised goods or services — An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due. In those cases, an entity should assess only the collectibility of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer on the basis of the entity's rights and customary business practices. Therefore, if the customer fails to perform as promised and, consequently, the entity would respond to the customer's failure to perform by not transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.

An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

The objective of the collectibility assessment is to determine whether there is a substantive transaction between the entity and the customer. There is deemed to be a substantive transaction between the two parties if it is probable that the entity will collect substantially all of the consideration attributed to goods or services that will be transferred to the customer. If the entity has an ability, and an established business practice, to mitigate collection risk by not transferring additional goods or services to a nonpaying customer, the entity would assess collectibility of only the consideration associated with the goods or services that will be transferred to the customer. Once the criteria in ASC 606-10-25-1 are met, the remainder of the guidance in ASC 606 should be applied to all of the promised goods or services in the contract. That is, an entity will assume that it will transfer all goods or services promised under the contract with its customer for purposes of identifying performance obligations, determining and allocating the transaction price, and recognizing revenue.

The following examples in ASC 606, which were added by ASU 2016-12, further illustrate the collectibility assessment:

ASC 606-10

Example 1 — Collectibility of the Consideration

[Case A omitted[5]]

Case B — Credit Risk Is Mitigated

55-98A An entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month.

[5] Case A of Example 1 is reproduced in Section 4.5.

ASC 606-10 (continued)

55-98B The transaction price of the contract is $720, and $20 is due at the end of each month. The standalone selling price of the monthly service is $20. Both parties are subject to termination penalties if the contract is cancelled.

55-98C The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of $720, the customer is expected to make the payments required under the contract for at least 9 months. If, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and to pursue collection for the unpaid services.

55-98D In assessing whether the contract meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer in accordance with paragraph 606-10-55-3B and its business practice of stopping service in response to customer nonpayment in accordance with paragraph 606-10-55-3C. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

55-98E It is not probable that the entity will collect the entire transaction price ($720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided). Consequently, assuming the criteria in paragraph 606-10-25-1(a) through (d) are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess the criteria in paragraph 606-10-25-1 if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

Case C — Credit Risk Is Not Mitigated

55-98F The same facts as in Case B apply to Case C, except that the entity's history with this class of customer indicates that there is a risk that the customer will not pay substantially all of the consideration for services received from the entity, including the risk that the entity will never receive any payment for any services provided.

55-98G In assessing whether the contract with the customer meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to the customer's nonpayment in accordance with paragraph 606-10-55-3C.

55-98H At contract inception, the entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the services that will be transferred to the customer. The entity concludes that not only is there a risk that the customer will not pay for services received from the entity, but also there is a risk that the entity will never receive any payment for any services provided. Subsequently, when the customer initially pays for one month of service, the entity accounts for the consideration received in accordance with paragraphs 606-10-25-7 through 25-8. The entity concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract, and the entity is continuing to provide services to the customer.

ASC 606-10 (continued)

55-98I Assume that the customer has made timely payments for several months. In accordance with paragraph 606-10-25-6, the entity assesses the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met. In making that evaluation, the entity considers, among other things, its experience with this specific customer. On the basis of the customer's performance under the contract, the entity concludes that the criteria in 606-10-25-1 have been met, including the collectibility criterion in paragraph 606-10-25-1(e). Once the criteria in paragraph 606-10-25-1 are met, the entity applies the remaining guidance in this Topic to recognize revenue.

Case D — Advance Payment

55-98J An entity, a health club, enters into a one-year membership with a customer of low credit quality. The transaction price of the contract is $120, and $10 is due at the beginning of each month. The standalone selling price of the monthly service is $10.

55-98K On the basis of the customer's credit history and in accordance with the entity's customary business practice, the customer is required to pay each month before the entity provides the customer with access to the health club. In response to nonpayment, the entity's customary business practice is to stop providing service to the customer upon nonpayment. The entity does not have exposure to credit risk because all payments are made in advance and the entity does not provide services unless the advance payment has been received.

55-98L The contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the entity will collect the consideration to which it will be entitled in exchange for the services that will be transferred to the customer (that is, one month of payment in advance for each month of service).

Thinking It Through — Forward-Looking Assessment

As noted in ASC 606-10-55-3B, the collectibility assessment is partly a forward-looking assessment that requires an entity to evaluate a customer's intention and ability to pay promised consideration when due. An entity may need to consider both the current and future financial condition of a customer when making this assessment. For example, in a situation involving a license of intellectual property (IP) for which consideration due is in the form of sales- and usage-based royalties, the entity may determine that the customer does not currently have the financial capacity to pay all of the expected sales- and usage-based royalties at contract inception; however, once the customer generates cash flows from the usage of the IP, it is expected that the customer will have the financial capacity to make the required payments when due. When performing its analysis, the entity would need to consider the customer's other payment obligations in addition to the royalty payments. That is, the entity could not solely rely on the cash generated from the use of the IP to conclude that it is probable that the customer will pay amounts when due. Rather, the entity would need to consider all relevant facts and circumstances when evaluating whether the customer has the intention and ability to pay amounts when due.

An entity may evaluate the collectibility criterion by analyzing its collection history with the same customer or similar types of customers (e.g., similar industry, size, geographical region). It should also consider any specifically identified events or circumstances related to the customer (e.g., the customer's deteriorating financial position or a default on the customer's loan covenant). Further, an entity may need to update its existing systems, processes, and controls in evaluating the customer's ability and intention to pay the consideration when due.

The Q&A below discusses whether an entity that has a portfolio of similar contracts should assess collectibility at the portfolio level or at the individual contract level.

Q&A 4-5 Assessing Collectibility for a Portfolio of Similar Contracts

Under ASC 606-10-25-1, collectibility is one of the criteria initially assessed to determine whether a contract with a customer should be accounted for under the general requirements of ASC 606. (ASC 606-10-25-7 delineates specific requirements for determining whether to recognize revenue when the criteria ASC 606-10-25-1 are not met.)

Under ASC 606-10-25-1(e), an assessment is required to determine whether it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will transfer to the customer. This assessment is based only on the customer's ability and intention to pay the amount of consideration to which the entity is entitled under the contract when it is due.

Question

If an entity has a portfolio of contracts that are all similar, including in terms of collectibility,[6] and historical evidence suggests that a proportion of the consideration due from contracts in the portfolio will not be collected, should the collectibility criterion be assessed at the individual contract level, or should the expected level of collectibility for the portfolio be used to estimate a number of contracts that will not meet the criterion?

Answer

Collectibility should be assessed at the individual contract level. For each individual contract, if it is considered probable that the entity will collect the consideration to which it will be entitled, the general requirements of ASC 606 should be applied.

For example, if the entity has a portfolio of 100 similar contracts and historical experience has indicated that the entity will only collect amounts due on 98 of those contracts, this does not suggest that there are two contracts that should not be accounted for under the general requirements of ASC 606. Rather, the entity should consider collectibility in the context of the individual contracts. If there is a 98 percent probability that amounts due under each contract will be collected, each contract will meet the criterion in ASC 606-10-25-1(e).

However, consideration should be given to any evidence that collection of amounts due under any specific contract is not probable. If that is considered to be the case, the specific contract does not meet the collectibility criterion and should be accounted for in accordance with ASC 606-10-25-7.

When a contract meets the criteria in ASC 606-10-25-1, including collectibility, the entity should recognize revenue as it satisfies its performance obligations under the contract on the basis of the amount of consideration to which it expects to be entitled (rather than the amount that it expects to collect). Therefore, for example, if the entity expects to be entitled to consideration of $500 from each of its contracts, it should recognize that $500 as revenue notwithstanding its historical experience of a 2 percent level of default.

[6] When assessing collectibility for a portfolio of contracts, an entity should not ignore information that suggests that there are specific (i.e., identified) contracts within a portfolio for which collectibility is not considered probable. In this scenario, those contracts should be excluded from the portfolio and considered on an individual basis. When the balance of evidence for a specific contract indicates that collectibility is not probable, the five-step model in ASC 606 should not be applied to that contract.

The entity should then evaluate any associated receivable or contract asset for impairment and present any difference between the measurement of the contract asset or receivable and the corresponding amount of revenue as an expense in accordance with ASC 310.

In the circumstances under consideration, this will result in recognized revenue of $50,000 ($500 × 100) and, assuming that the estimated 98 percent collection rate proves accurate, impairment (bad debts) of $1,000 ($50,000 × 2%).

The TRG discussed this issue in January 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 25. For additional information and Deloitte's summary, see Appendixes D and E.

4.3 Contract Term

Determining the term of the contract is an important step in the revenue recognition process since the contract term could affect the identification of promises under the contract as well as the transaction price. ASC 606 provides guidance on determining the contract duration, including the effect of termination clauses and contract renewals. The contract term is determined on the basis of the period over which the parties to the contract have present enforceable rights and obligations. The contract term would not include optional renewal periods or the delivery of optional goods or services. However, the existence of purchase options in a contract with a customer could give rise to a material right. For further discussion of material rights, see Section 5.6.

ASC 606-10

25-3 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

TRG Update — Termination Clauses and Penalties

Various stakeholders raised implementation concerns regarding the enforceability of contracts and contracts with termination clauses and penalties. The TRG noted that the duration of a contract is predicated on the contract's enforceable rights and obligations. Accordingly, regardless of whether one or both parties have the right to terminate the contract, an entity would need to evaluate the nature of the termination provisions, including whether they are substantive. For example, an entity would assess factors such as (1) whether the terminating party is required to pay compensation, (2) the amount of such compensation, and (3) the reason for the compensation (i.e., whether the compensation is in addition to amounts due for goods and services already delivered). Substantive termination penalties suggest that the parties' rights and obligations extend for the duration of the contract term.

TRG members acknowledged that the determination of whether a termination provision is substantive will require judgment and would be evaluated both quantitatively and qualitatively. Some offered that data about the frequency of contract terminations may be useful in such a determination (i.e., a high frequency of payments made to terminate contracts may suggest that the termination provision is not substantive).

Further, TRG members generally agreed that a contract's accounting term could be less than the contract's stated term if termination provisions are not substantive. That is, a 12-month stated contract term could, in effect, be a month-to-month contract if the contract could be terminated and the termination penalties are not substantive. An entity will need to carefully consider the effect of nonsubstantive termination provisions and clauses on the timing and amount of revenue to be recognized.

Determining the enforceable term of a contract that includes termination provisions (e.g., cancellation fees) may be challenging, particularly when only the customer has a right to terminate the contract.

Thinking It Through — Termination Provisions Without Penalty in Fixed-Term Contracts

Stakeholders have raised implementation questions related to fixed-term contracts that allow a customer to terminate the contract without penalty. For example, suppose that a supplier has a contract to deliver various goods and services to a customer. The contract includes pricing for the goods or services for a two-year period but allows the customer to cancel the contract at any time after six months. In this scenario, we generally believe that the enforceable rights and obligations of the contract are for six months; therefore, the contractual term is six months. Since the pricing terms of the arrangement are fixed for two years, the entity would also need to evaluate whether a material right exists for purchases beyond six months.

4.4 Reassessing the Criteria for Identifying a Contract

An entity is required to evaluate the criteria in ASC 606-10-25-1 at contract inception to determine whether a valid and genuine transaction exists for accounting purposes. Once an entity concludes that the criteria are met (i.e., that a valid contract exists), it is not required to reassess the criteria unless there has been a significant change in facts and circumstances. A reassessment may be required, for example, if an entity determines that its remaining contractual rights and obligations are no longer enforceable or if other changes suggest that a valid and genuine transaction no longer exists.

ASC 606-10

25-5 If a contract with a customer meets the criteria in paragraph 606-10-25-1 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C).

25-6 If a contract with a customer does not meet the criteria in paragraph 606-10-25-1, an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met.

TRG Update — How to Evaluate the Reassessment Criteria

Stakeholders have questioned how to evaluate the reassessment criteria in ASC 606-10-25-5 to determine when to reassess whether a contract continues to meet the collectibility threshold. The TRG discussed this topic and noted that the assessment of whether a significant change in facts and circumstances occurred will be situation-specific and will often be a matter of judgment.

The Q&A below discusses whether an entity is required to reassess the criteria in ASC 606-10-25-1 when collectibility issues arise after contract inception.

Q&A 4-6 Reassessment of Collectibility

ASC 606-10-25-1 lists criteria that must be met for an entity to determine that it has a contract with a customer. Among them is the criterion in ASC 606-10-25-1(e), which requires that "[i]t is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer."

There may be situations in which an entity concludes at contract inception that the criterion in ASC 606-10-25-1(e) is met but subsequent changes in circumstances lead the entity to question whether it will collect consideration from the customer.

Question

After the inception of a contract, if concerns arise regarding the collectibility of the consideration due from a customer, is an entity required to reassess the criteria in ASC 606-10-25-1?

Answer

Yes, in limited circumstances. In general, once an entity makes a determination that a contract exists in accordance with ASC 606-10-25-1, the determination is not reevaluated. However, in accordance with ASC 606-10-25-5, an entity should reassess the criteria in ASC 606-10-25-1 when "there is an indication of a significant change in facts and circumstances" (i.e., changes that might call into question the existence of a contract rather than minor changes that might reasonably be expected over the contract term, particularly for long-term contracts).

As a result, when concerns arise regarding the collectibility of consideration, an entity will need to use judgment to determine whether those concerns arise from a significant change in facts and circumstances in the context of ASC 606-10-25-5.

Example 4 in ASC 606-10-55-106 through 55-109 illustrates when a change in the customer's financial condition is so significant that a reassessment of the criteria in ASC 606-10-25-1 is required. As a result of the reassessment, the entity determines that the collectibility criterion is not met and that the contract therefore fails step 1. Accordingly, the entity is precluded from recognizing additional revenue under the contract until the criteria in ASC 606-10-25-7 are met or collectibility becomes probable. The entity also assesses any related contract assets or accounts receivable for impairment.

The TRG discussed this issue in January 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 25. For additional information and Deloitte's summary, see Appendixes D and E.

If an entity is required to reassess its contract because of a significant change in facts and circumstances, the criteria in ASC 606-10-25-1 would only be evaluated in the context of the remaining goods or services that have yet to be provided. The reassessment would not affect any assets or revenue that has been recognized from satisfied performance obligations. However, assets would need to be evaluated for impairment under other applicable guidance (e.g., the guidance in ASC 310 on accounts receivable or the FASB's new credit loss guidance in ASC 326).

The following example in ASC 606 illustrates when an entity would reassess its contract in accordance with the criteria in ASC 606-10-25-1:

ASC 606-10

Example 4 — Reassessing the Criteria for Identifying a Contract

55-106 An entity licenses a patent to a customer in exchange for a usage-based royalty. At contract inception, the contract meets all the criteria in paragraph 606-10-25-1, and the entity accounts for the contract with the customer in accordance with the guidance in this Topic. The entity recognizes revenue when the customer's subsequent usage occurs in accordance with paragraph 606-10-55-65.

55-107 Throughout the first year of the contract, the customer provides quarterly reports of usage and pays within the agreed-upon period.

55-108 During the second year of the contract, the customer continues to use the entity's patent, but the customer's financial condition declines. The customer's current access to credit and available cash on hand are limited. The entity continues to recognize revenue on the basis of the customer's usage throughout the second year. The customer pays the first quarter's royalties but makes nominal payments for the usage of the patent in quarters 2–4. The entity accounts for any impairment of the existing receivable in accordance with Topic 310 on receivables.

55-109 During the third year of the contract, the customer continues to use the entity's patent. However, the entity learns that the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates. The entity therefore concludes that it is unlikely that the customer will be able to make any further royalty payments for ongoing usage of the entity's patent. As a result of this significant change in facts and circumstances, in accordance with paragraph 606-10-25-5, the entity reassesses the criteria in paragraph 606-10-25-1 and determines that they are not met because it is no longer probable that the entity will collect the consideration to which it will be entitled. Accordingly, the entity does not recognize any further revenue associated with the customer's future usage of its patent. The entity accounts for any impairment of the existing receivable in accordance with Topic 310 on receivables.

4.5 Consideration Received When the Criteria for Identifying a Contract Are Not Met

If a contract does not meet the criteria in ASC 606-10-25-1 at contract inception, no revenue can be recognized until either the contract existence criteria are met or other conditions are satisfied. That is, any consideration received from a customer, including nonrefundable consideration, is precluded from being recognized as revenue until certain events have occurred.

ASC 606-10

25-7 When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

ASC 606-10 (continued)

25-8 An entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 606-10-25-7 occurs or until the criteria in paragraph 606-10-25-1 are subsequently met (see paragraph 606-10-25-6). Depending on the facts and circumstances relating to the contract, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

Thinking It Through — Framework Provided by the Contract Existence Criteria

The contract existence criteria provide a framework for determining when a contract with a customer includes all of the elements required to apply the rest of the revenue recognition model. The model relies on a complete analysis of the rights and obligations under the contract. For an entity to recognize revenue in an amount that depicts the consideration to which it expects to be entitled in exchange for promised goods or services, the entity needs to be able to adequately determine both the promised goods or services and the consideration to which it expects to be entitled (along with meeting the other criteria). When any of the contract existence criteria are not met (including the collectibility threshold), the entity is unable to determine how to allocate consideration to promised goods or services under the contract because either the promised consideration or the promised goods or services are inadequately defined. Consequently, even if nonrefundable consideration is received from a customer and the entity has transferred some of the goods or services promised under the contract, if the contract existence criteria are not met and none of the events in ASC 606-10-25-7 have occurred, the entity is unable to conclude that the consideration received is related entirely to satisfied (or partially satisfied) performance obligations. Therefore, any such consideration received needs to be recorded as a liability until the entity determines that either the contract existence criteria are met or one of the events in ASC 606-10-25-7 has occurred.

ASU 2014-09 did not include the criterion in ASC 606-10-25-7(c). In some cases, questions arose about whether the criterion in ASC 606-10-25-7(b) was met — specifically, whether a contract can be deemed to be terminated if goods or services were transferred to a customer and some nonrefundable consideration was received, but the customer paid less than the full transaction price and the entity continued to pursue collection of outstanding balances to which it was entitled. ASU 2016-12 added a third criterion, ASC 606-10-25-7(c),[7] to enable an entity to recognize consideration received from a customer as revenue when the contract does not meet the criteria in ASC 606-10-25-1 if (1) the "entity has transferred control of the goods or services to which the consideration that has been received relates," (2) "the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services," and (3) "the consideration received from the customer is nonrefundable."

When the events described in ASC 606-10-25-7(c) occur, it will be evident that nonrefundable consideration received from a customer is entirely related to satisfied performance obligations (or satisfied portions of a performance obligation that is satisfied over time). That is, the customer will no longer have rights to obtain additional goods or services from the entity, and the entity has no further obligation (or intention) to transfer goods or services to the customer. In these circumstances, the contract can be accounted for as if it were terminated (i.e., revenue can be recognized for the nonrefundable consideration received) even if the entity continues to pursue collection of outstanding balances from the customer.

[7] The IASB did not amend IFRS 15 to add this third criterion. For a summary of differences between ASC 606 and IFRS 15, see Appendix A.

The following example in ASC 606 illustrates the accounting for a contract that fails to meet the criteria in ASC 606-10-25-1:

ASC 606-10

Example 1 — Collectibility of the Consideration

Case A — Collectibility Is Not Probable

55-95 An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.

55-96 The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.

55-97 The entity concludes that not all of the criteria in paragraph 606-10-25-1 are met. The entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).
b. The customer lacks other income or assets that could be used to repay the loan.
c. The customer's liability under the loan is limited because the loan is nonrecourse.

55-98 The entity continues to assess the contract in accordance with paragraph 606-10-25-6 to determine whether the criteria in paragraph 606-10-25-1 are subsequently met or whether the events in paragraph 606-10-25-7 have occurred.

As noted above, if an entity determines that collectibility from the customer is not probable, no contract is deemed to exist for accounting purposes and the new revenue standard's five-step model cannot be applied. If the entity nevertheless decides to transfer its promised goods or services before collecting consideration from its customer and the collection of such consideration is not probable, a question arises about whether the entity can recognize a receivable for the amount of consideration to which it is legally entitled.

Q&A 4-7 Recording a Receivable When a Contract Fails Step 1 (Because Collectibility Is Not Probable)

ASC 606-10-45-4 states that a "receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. . . . An entity shall account for a receivable in accordance with [ASC] 310."

In addition, ASC 606-10-25-1 lists five criteria that must all be met for an entity to account for a contract with a customer under step 1 of the new revenue model. One of those criteria (ASC 606-10-25-1(e)) is that "[i]t is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer."

Question

Can an entity record a receivable if it transfers a good or service to its customer but the accounting contract fails step 1 because collectibility of the expected consideration is not probable?

Answer

Generally, no. While an entity may have a legal contract, if it cannot conclude that a contract exists from an accounting perspective, it cannot recognize revenue and typically would not recognize a receivable.

Case A of Example 1 in the new revenue standard (ASC 606-10-55-95 through 55-98) illustrates a situation in which an entity concludes that it does not have a contract with a customer because one of the criteria in ASC 606-10-25-1 is not met — specifically, collectibility of the expected consideration is not probable. In the new revenue standard as originally issued, the example[8] included the following text (subsequently deleted from ASC 606-10-55-98 by ASU 2016-12), which we still believe appropriately reflects the treatment of contracts that have not yet met the criteria in step 1:

> Because the criteria in paragraph 606-10-25-1 are not met, the entity applies paragraphs 606-10-25-7 through 25-8 to determine the accounting for the nonrefundable deposit of $50,000. The entity observes that none of the events described in paragraph 606-10-25-7 have occurred — that is, the entity has not received substantially all of the consideration and it has not terminated the contract. Consequently, in accordance with paragraph 606-10-25-8, the entity accounts for the nonrefundable $50,000 payment as a deposit liability. The entity continues to account for the initial deposit, as well as any future payments of principal and interest, as a deposit liability and does not derecognize the real estate asset. Also, **the entity does not recognize a receivable until such time that the entity concludes that the criteria in paragraph 606-10-25-1 are met (that is, the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 606-10-25-7 has occurred**. [Emphasis added]

While this aspect of the answer to the question was deleted by ASU 2016-12, it was deleted because the example was revised to focus only on the evaluation of the collectibility threshold. We believe that the principle in the original example is still appropriate and that a receivable would generally not be recognized if goods or services are transferred to a customer but the contract fails step 1 because collectibility is not probable.

However, ASC 606-10-45-1 states that "[w]hen either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable." This supports the conclusion that if an entity can demonstrate that it has a legally enforceable contract with an unconditional and immediate right to payment, it may be acceptable for the entity to recognize a receivable and a corresponding contract liability. That is, the arrangement may not be considered a contract under ASC 606 (e.g., because collectibility is not probable), but because the contract is legally enforceable, the entity has an unconditional right to payment. Consequently, the ASC 310 definition of a receivable is met, and it may be acceptable for the entity to recognize a receivable.

[8] That is, what the new revenue standard, as amended by ASU 2016-12, refers to as Case A of Example 1. Before ASU 2016-12 was issued, Example 1 had only one fact pattern.

When an entity has a right to recover products from customers, it may be acceptable for the entity to record an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability. For example, if the entity is unable to conclude that a contract has met all of the step 1 criteria because collectibility of the expected consideration is not probable, but the entity has already transferred inventory to the customer, the entity may record an asset for the right to the inventory if the legal contract stipulates that the entity has the right to take back the inventory in the event that the customer does not pay.

4.6 Combining Contracts

Generally, the new revenue standard is applied at the individual contract level unless the portfolio approach has been elected (see Section 3.1.2.2). However, an entity's contracting practice could result in a single arrangement with a customer that is governed by multiple legal contracts. That is, the commercial substance of a single arrangement to provide goods or services to a customer could be addressed by multiple contracts with the same customer. In a manner similar to the accounting under current revenue recognition guidance, the new revenue standard requires multiple contracts with a customer to be combined and accounted for as a single contract when certain conditions are present.

ASC 606-10

25-9 An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

a. The contracts are negotiated as a package with a single commercial objective.
b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

The contract combination guidance should be assessed at contract inception. An entity will need to use judgment in determining whether multiple contracts are "entered into at or near the same time." As a general rule, the longer the period between entering contracts with the same customer, the more likely those contracts are not economically linked.

Thinking It Through — Consistency With Current Guidance

The requirement for combining contracts is generally consistent with current U.S. GAAP for entities applying the guidance in ASC 985-605 or ASC 605-25. As a result, those entities may not be significantly affected by the contract combination guidance in the new revenue standard.

4.7 Wholly Unperformed Contracts

An entity may have entered into a legal contract with a customer under which neither party has performed and either party can cancel the contract for no consideration.

ASC 606-10

25-4 For the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

a. The entity has not yet transferred any promised goods or services to the customer.
b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

As previously discussed in Section 4.2.1, the new revenue standard does not apply to wholly unperformed contracts that allow either party the unilateral ability to terminate a contract. However, the standard would apply if only one party could terminate the contract. For example, an entity's customer may have the ability to terminate a wholly unperformed contract without incurring a termination penalty while the entity is required to provide goods or services if called upon by the customer. Since the entity is obligated to provide goods and services at the discretion of the customer, the entity is providing a stand-ready service to its customer that would need to be evaluated under ASC 606. See Section 4.3 above for further discussion of termination provisions.

4.8 Modifying Contracts

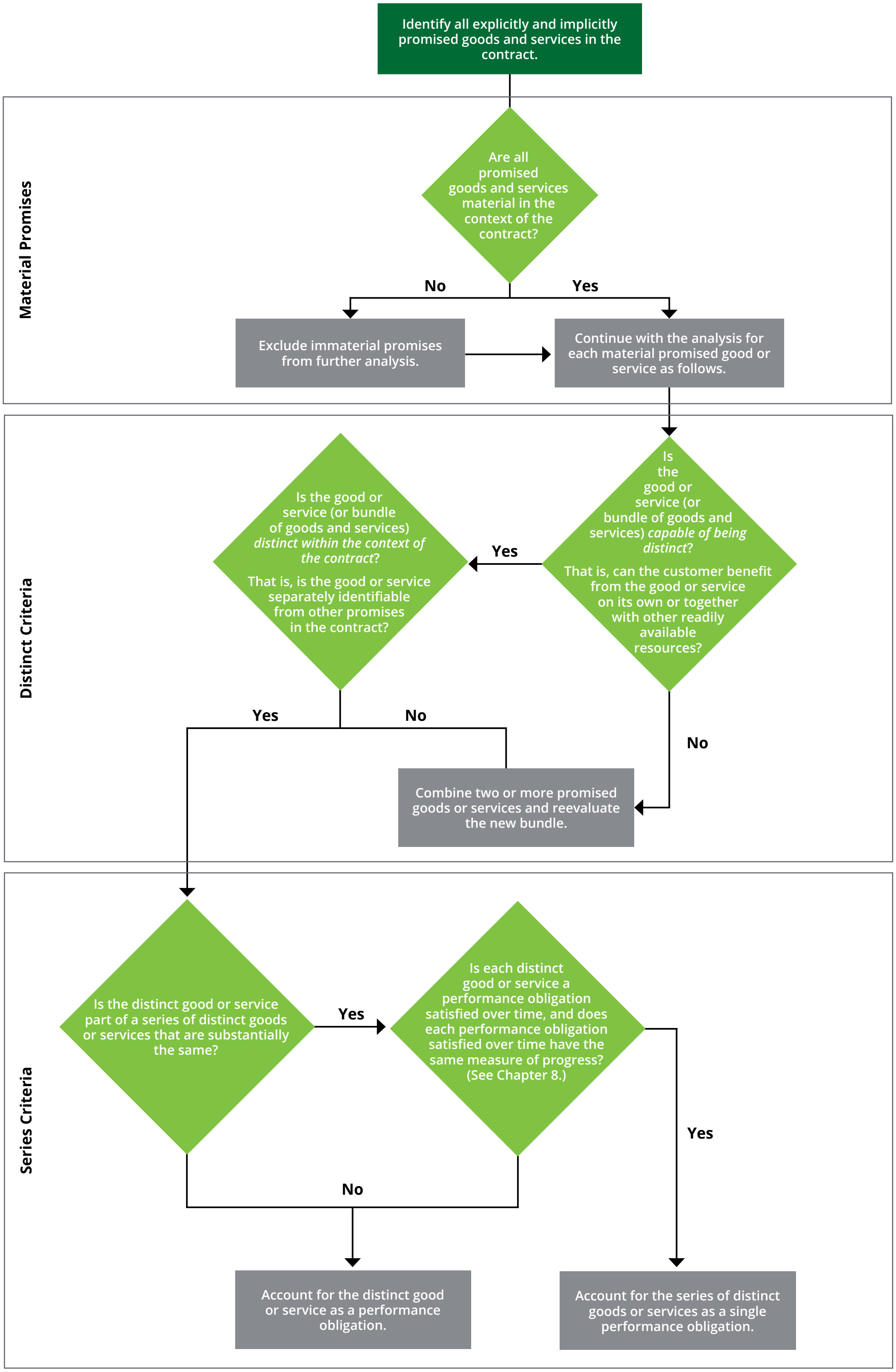
A contract may be modified after an entity has already accounted for some or all of the revenue related to that contract. The impact on revenue recognition will depend on how that contract has been modified. This is discussed in Chapter 9.

Chapter 5 — Step 2: Identify the Performance Obligations

5.1 Introduction to Step 2

Step 2 is one of the most critical steps in the new revenue framework since it establishes the unit of account for revenue recognition. A material miscalculation in this step will often lead to an error in the recognition of revenue. This step requires an entity to identify what it has promised to the customer. In many arrangements, this will be obvious and therefore simple; in other arrangements, however, there are critical judgments that an entity must make in determining the correct unit of account (i.e., performance obligation).

The decision tree below illustrates the new revenue standard's process for identifying performance obligations in a contract.


Identify all explicitly and implicitly promised goods and services in the contract.
Material Promises
Are all promised goods and services material in the context of the contract?
No
Yes
Exclude immaterial promises from further analysis.
Continue with the analysis for each material promised good or service as follows.
Distinct Criteria
Is the good or service (or bundle of goods and services) *capable of being distinct*?
That is, can the customer benefit from the good or service on its own or together with other readily available resources?
Yes
Is the good or service (or bundle of goods and services) *distinct within the context of the contract*?
That is, is the good or service separately identifiable from other promises in the contract?
Yes
No
No
Combine two or more promised goods or services and reevaluate the new bundle.
Series Criteria
Is the distinct good or service part of a series of distinct goods or services that are substantially the same?
Yes
Is each distinct good or service a performance obligation satisfied over time, and does each performance obligation satisfied over time have the same measure of progress? (See Chapter 8.)
Yes
No
Account for the distinct good or service as a performance obligation.
Account for the series of distinct goods or services as a single performance obligation.

This chapter also discusses topics such as stand-ready obligations, options for additional goods and services, warranties, and nonrefundable up-front fees because they could lead to identifying performance obligations.

When identifying a performance obligation, an entity should determine whether it is a principal or an agent in the transaction because that determination will affect how (and sometimes when) the entity reports the revenue earned. While step 2 is probably the best stage of the revenue recognition process for determining whether an entity is a principal or an agent, there are many considerations that go into that determination. Accordingly, principal-versus-agent considerations are discussed separately in Chapter 10.

5.2 Promises in Contracts With Customers

5.2.1 In General

Identification of all promises in a contract is important because promises are what comprise performance obligations and entities recognize revenue on the basis of the satisfaction of performance obligations. ASC 606-10-25-18 lists examples of what could constitute a promise in a contract:

ASC 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 55-60 and paragraphs 606-10-55-62 through 55-65B)
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).

5.2.2 Implied Promises

ASC 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 promised goods and services 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 reasonable expectation of the customer that the entity will transfer a good or service to the customer.

For some contracts, it will be easy to identify all promises because they are all specifically stated. However, the FASB and IASB decided to require entities to identify the implied promises as well. The reason for the boards' decision, as discussed in paragraph BC87 of ASU 2014-09, was to ensure that all of the promises in a contract are appropriately identified so that when an entity allocates consideration to the performance obligations identified, it will recognize revenue when control of all of the promised goods and services in the contract is transferred to the customer. Paragraph BC87 goes on to state, "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)."

Thinking It Through — Implied Promises

This concept is important because if an entity does not identify an implied promise in a contract, it could recognize revenue at the wrong time. For example, the entity could recognize all revenue from the contract because it has satisfied all explicitly stated promises in the contract. However, because the entity still has an unidentified implied promise to satisfy for the customer, no consideration was allocated to that promise. As a result, the entity recognized more revenue from the contract than it should have at that point.

The guidance on implied promises will require an entity to use judgment to determine whether a customer has an expectation based on customary business practices or the entity's previous transactions with the customer that the entity will provide a good or service not specifically stated in the contract. Because of the requirements in, and current interpretations of, the guidance in ASC 985-605, entities applying the new revenue standard's requirements to software arrangements may see less of a change in applying and operationalizing the guidance on implied promises than in other industries.

5.2.2.1 Illustrative Examples of Explicit and Implicit Promises (ASC 606-10-55-151 Through 55-157A)

Cases A, B, and C of Example 12 in ASC 606, which are reproduced below, further discuss explicit and implicit promises.

ASC 606-10

Example 12 — Explicit and Implicit Promises in a Contract

55-151 An entity, a manufacturer, sells a product to a distributor (that is, its customer), who will then resell it to an end customer.

ASC 606-10 (continued)

Case A — Explicit Promise of Service

55-152 In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (that is, "free") to any party (that is, the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.

55-153 The contract with the customer includes two promised goods or services — (a) the product and (b) the maintenance services (because the promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor). The entity assesses whether each good or service is distinct in accordance with paragraph 606-10-25-19. The entity determines that both the product and the maintenance services meet the criterion in paragraph 606-10-25-19(a). The entity regularly sells the product on a standalone basis, which indicates that the customer can benefit from the product on its own. The customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (that is, the product).

55-153A The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable (in accordance with paragraph 606-10-25-19(b)) on the basis of the principle and the factors in paragraph 606-10-25-21. The product and the maintenance services are not inputs to a combined item in this contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customize the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to satisfy each of the promises in the contract independent of its efforts to satisfy the other (that is, the entity would be able to transfer the product even if the customer declined maintenance services and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, in applying the principle in paragraph 606-10-25-21, that the entity's promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer. Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (that is, the product and the maintenance services) in the contract.

Case B — Implicit Promise of Service

55-154 The entity has historically provided maintenance services for no additional consideration (that is, "free") to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor, and the final contract between the entity and the distributor does not specify terms or conditions for those services.

55-155 However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create reasonable expectations of the entity's customers (that is, the distributor and end customers) in accordance with paragraph 606-10-25-16. Consequently, the entity assesses whether the promise of maintenance services is a performance obligation. For the same reasons as in Case A, the entity determines that the product and maintenance services are separate performance obligations.

Case C — Services Are Not a Promised Service

55-156 In the contract with the distributor, the entity does not promise to provide any maintenance services. In addition, the entity typically does not provide maintenance services, and, therefore, the entity's customary business practices, published policies, and specific statements at the time of entering into the contract have not created an implicit promise to provide goods or services to its customers. The entity transfers control of the product to the distributor and, therefore, the contract is completed. However, before the sale to the end customer, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.

ASC 606-10 (continued)

55-157 The promise of maintenance is not included in the contract between the entity and the distributor at contract inception. That is, in accordance with paragraph 606-10-25-16, the entity does not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers. Consequently, the entity does not identify the promise to provide maintenance services as a performance obligation. Instead, the obligation to provide maintenance services is accounted for in accordance with Topic 450 on contingencies.

55-157A Although the maintenance services are not a promised service in the current contract, in future contracts with customers the entity would assess whether it has created a business practice resulting in an implied promise to provide maintenance services.

5.2.3 Immaterial Promises

ASC 606-10

25-16A An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

25-16B An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

When the FASB and IASB were developing the new revenue standard, they received feedback, as noted in paragraph BC88 of ASU 2014-09, that there can be situations in which promises in contracts could be considered "marketing expenses or incidental obligations." The boards considered the feedback but decided that allowing management to determine whether promises are a marketing expense would result in too much subjectivity on the part of management and therefore could lead to inconsistent application of the concept. As a result, the boards determined that every promise, either on its own or jointly with other promises, should give rise to a performance obligation.

Because of the wording in paragraphs BC87 through BC90 of ASU 2014-09, some stakeholders questioned whether the FASB and IASB intended performance obligations that are not identified as deliverables under existing revenue guidance to be identified as performance obligations under the new standard. Unlike the SEC's guidance in SAB Topic 13.A, the revenue standard does not contain guidance on "inconsequential or perfunctory" items. In fact, the Basis for Conclusions of ASU 2014-09 notes that 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."

Accordingly, questions arose about whether it was necessary for an entity to identify immaterial goods or services when identifying performance obligations.

On April 14, 2016, the FASB issued ASU 2016-10,[1] which states that an entity "is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer." In addition, the ASU indicates that an entity should consider materiality of items or activities only at the contract level (as opposed to aggregating such items and performing an assessment at the financial statement level). This change should not apply to an entity's assessment of optional goods and services offered to a customer, which the entity must evaluate under ASC 606-10-55-42 and 55-43 to determine whether they give the customer a material right (i.e., an optional good offered for free or at a discount, such as that provided through loyalty point programs, may not be material for an individual contract but could be material in the aggregate and accounted for as a material right). Material rights are further discussed in Section 5.6.

The ASU permits entities to choose not to evaluate whether immaterial items or activities represent performance obligations. Thus, the exclusion of such immaterial items or activities under the new revenue standard would not be considered a departure from GAAP and need not be aggregated as a misstatement.

The Q&A below discusses an assessment of immaterial promised goods or services within the context of ASU 2016-10.

Q&A 5-1 Accounting for Perfunctory or Inconsequential Performance Obligations

An entity may enter into a contract in which it promises to transfer Product A and Item B to a customer. Product A and Item B meet the criteria in ASC 606-10-25-19 to be considered distinct and do not meet the criteria in ASC 606-10-25-14(b) (i.e., they do not constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer). Item B may be either a substantive promise in the arrangement (e.g., free maintenance on Product A for two years) or inconsequential (e.g., certain promises to participate in a joint committee, delivery of an installation or training manual, a simple installation process that only requires unpacking and plugging in, a simple inspection service).

Question

If Item B is considered perfunctory or inconsequential, does that mean that under ASC 606 it can be ignored?

Answer

No. Perfunctory or inconsequential promises in a contract may be, but are not presumed to be, immaterial in the context of the contract. As a result, an entity may need to reevaluate historical conclusions by using the new framework outlined in ASC 606-10-25-16A and 25-16B.

[1] The IASB did not amend IFRS 15 to expressly address immaterial promises. Accordingly, IFRS 15 does not include similar guidance on determining the materiality of promised goods or services. Rather, an entity's overall materiality considerations should be used in the evaluation of promised goods or services under IFRS 15. The boards do not expect a significant difference in application. For a summary of differences between IFRS 15 and ASC 606, see Appendix A.

Thinking It Through — Framework for Identifying Immaterial Promised Goods or Services

ASU 2016-10 provides the following guidance on immaterial promised goods or services:

> **[ASC] 606-10-25-16A** An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.
>
> **[ASC] 606-10-25-16B** An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

In light of the ASU's wording, stakeholders have asked about the framework an entity should use to identify a potential good or service that is immaterial in the context of the contract. The following have been considered, both of which we think are relevant to the assessment of whether a good or service is immaterial in the context of the contract:

- An entity may conclude that a potential good or service is immaterial in the context of the contract if the estimated stand-alone selling price of the potential good or service is immaterial (quantitatively) compared with the total consideration in the contract (i.e., the amount that would be allocated to such good or service is immaterial in the context of the contract).
- An entity may conclude that a potential good or service is immaterial in the context of the contract if it determines that the customer does not consider the potential good or service material to the contract (i.e., the entity would evaluate qualitative factors, including the customer's perspective, in determining whether a potential good or service is immaterial in the context of the contract).

In addition, we think that when an entity performs an assessment to identify immaterial promised goods or services, it should also consider the guidance in ASU 2016-10 on customer options (i.e., potential material rights) as well as the SEC staff's view of "material" as discussed in SAB Topic 1.M.

5.2.4 Consideration of Activities

ASC 606-10

25-17 Promised goods or services 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 promised goods or services in the contract with the customer.

There is a difference between promises and activities in contracts. The FASB and IASB wanted this to be clear because the new revenue standard is based on recognizing revenue as an entity transfers control of goods or services to customers. When an entity promises goods and services to customers, it is going to transfer those goods or services to the customers. In contrast, activities that an entity is required to undertake to fulfill promises in a contract do not necessarily transfer goods or services to the customer. Therefore, since the completion of an activity does not represent transfer of control, an entity would not recognize revenue on the basis of the completion of an activity.

The Q&A below illustrates the difference between an activity and a promise.

Q&A 5-2 Assessing Whether a Preproduction Activity Forms Part of the Delivery of a Promised Good or Service

In some long-term supply arrangements, before goods can be delivered to a customer, an entity may be required to undertake preproduction activities such as "up-front" engineering and design (e.g., to create new technology or adapt existing technology to the needs of the customer). Because of the nature of the underlying tasks, preproduction activities are often carried out over time.

If a preproduction activity transfers a good or service to a customer as the preproduction activity is carried out, it will be appropriate, subject to the other requirements of ASC 606, to recognize revenue as the preproduction activity is carried out.[2]

If a preproduction activity does not transfer a good or service to a customer as the preproduction activity is carried out, no revenue should be recognized as the preproduction activity is carried out. Instead, the associated costs should either be capitalized (if they meet the criteria in ASC 340-40-25-5) or expensed as incurred.

Question

How should an entity evaluate whether a preproduction activity transfers a good or service to a customer as the preproduction activity is carried out (such that it may be appropriate to recognize revenue as that activity is performed)?

Answer

An entity should identify the nature of its promise(s) to the customer to determine whether the preproduction activity represents either of the following:

- A promised good or service (or part of a promised good or service) that is transferred to the customer.
- A fulfillment activity that does not transfer a good or service to the customer.

In making this determination, an entity will need to use judgment. In addition to the guidance in ASC 606-10-25-14 through 25-22 on identifying performance obligations, an entity might look to the guidance in ASC 606-10-25-27 through 25-29 on satisfying a performance obligation over time.

One scenario in which a performance obligation is satisfied over time is when the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see ASC 606-10-25-27(a)). A determination that the customer simultaneously receives and consumes benefits as the entity carries out the preproduction activity would indicate that the preproduction activity forms part of a performance obligation. In the entity's assessment of whether the customer simultaneously receives and consumes benefits, it may be helpful to consider, in accordance with ASC 606-10-55-6, whether another entity would need to substantially reperform the preproduction activities if that other entity were to fulfill the remaining performance obligation to the customer. When making this assessment, the reporting entity should assume that the other entity would not have the benefit of any asset that the reporting entity would continue to control if the contract were terminated.

[2] Such a preproduction activity could be a performance obligation in its own right or could form part of a larger performance obligation.

Another scenario in which a performance obligation is satisfied over time is when the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. A determination that the preproduction activity creates or enhances an asset that the customer controls as the asset is created or enhanced would indicate that the preproduction activity forms part of a performance obligation.

Example

An entity enters into a contract with a customer to develop and produce a new product. As part of its development of that new product for the customer, the entity performs engineering and development activities. The entity determines that (1) the customer will own the intellectual property (patents) that results from those activities and (2) those activities are creating an asset that the customer controls as the asset is created.

Accordingly, the entity concludes that (1) the engineering and development activities are transferring a good or service to the customer over time and (2) those activities form part of the performance obligation(s) in the contract with the customer.

The TRG discussed this issue in November 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 49. For additional information and Deloitte's summary, see Appendixes D and E.

5.2.4.1 Promise to Stand Ready to Accept a Returned Product

The Q&A below explains whether an entity that promises to make itself available to accept a return should identify that promise as a performance obligation. (For further discussion of sales with a right of return, see Section 6.2.5.3. For stand-ready obligations to provide goods or services, see Section 5.4.2.)

Q&A 5-3 Whether an Entity's Promise to Stand Ready to Accept a Returned Product During the Return Period Is a Performance Obligation in Addition to the Obligation to Provide a Refund

Entities often offer customers the right to return a product within a certain period after its initial sale, provided that the product has not been used or damaged.

Question

Is an entity's promise to stand ready to accept a returned product during the return period a performance obligation in addition to the obligation to provide a refund?

Answer

No. ASC 606-10-55-24 states that "[a]n entity's promise to stand ready to accept a returned product during the return period **should not be accounted for as a performance obligation** in addition to the obligation to provide a refund" (emphasis added). Therefore, a right of return is not a separate performance obligation. However, a customer's right to return a product may affect the amount of revenue recognized (the transaction price) because revenue may only be recognized for goods that are not expected to be returned.

5.2.4.2 Shipping and Handling Activities

ASC 606-10

25-18A An entity that promises a good to a customer also might perform shipping and handling activities related to that good. If the shipping and handling activities are performed before the customer obtains control of the good (see paragraphs 606-10-25-23 through 25-30 for guidance on satisfying performance obligations), then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity's promise to transfer the good.

25-18B If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The entity shall apply this accounting policy election consistently to similar types of transactions. An entity that makes this election would not evaluate whether shipping and handling activities are promised services to its customers. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued. An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

Under existing revenue guidance, an entity generally does not account for shipping services that it provides in conjunction with the sale of its products as an additional deliverable. Stakeholders asked the FASB to clarify whether shipping and handling services that do not represent the predominant activity in the contract should be accounted for as a promised service (i.e., potentially a separate performance obligation to which a portion of the transaction price must be allocated) or as a fulfillment cost that should be accounted for under the new fulfillment cost guidance in ASC 340-40.

On April 14, 2016, the FASB issued ASU 2016-10,[3] which permits an entity to account for shipping and handling activities that occur after the customer has obtained control of a good as fulfillment activities (i.e., an expense) rather than as a promised service (i.e., a revenue element). An entity may also elect to account for shipping and handling activities that occur after control of the good is transferred to the customer as a promised service. When the practical expedient is elected and revenue for the related good is recognized before the shipping and handling activities occur, the entity should accrue the costs of the shipping and handling activities at the time control of the related good is transferred to the customer (i.e., at the time of sale).

ASU 2016-10 also explains that shipping and handling activities performed before control of a product is transferred do not constitute a promised service to the customer in the contract (i.e., they represent fulfillment costs).

Thinking It Through — Applicability of Accounting Policy Election

The election to account for shipping and handling services as a promised service (a revenue element) or a fulfillment activity (a cost element) typically should not apply to entities whose principal service offering is shipping or transportation. Further, we believe that such election (1) should be applied consistently and (2) is available to entities that recognize revenue for the sale of goods either at a point in time or over time.

[3] The IASB did not amend IFRS 15 to expressly address shipping and handling activities. Accordingly, IFRS 15 does not include similar elections. See Appendix A for a summary of differences between IFRS 15 and ASC 606.

5.3 Identifying Performance Obligations in a Contract

5.3.1 In General

After identifying the promises in a contract with a customer, an entity must determine whether a promise or multiple promises represent performance obligations to the customer. To accomplish this, the entity should determine whether the promises in the contract are *distinct* in accordance with ASC 606-10-25-14.

ASC 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).**

Changing Lanes — Deliverables

The concept of grouping deliverables into units of accounting under current U.S. GAAP is similar to that of grouping promises into performance obligations under the new revenue standard; however, the method for identifying a performance obligation is different under the new guidance. Under current U.S. GAAP, ASC 605-25 requires an entity to identify units of accounting by determining (1) whether the delivered item or items have stand-alone value to the customer and (2) whether, if there is a generic right of return relative to the delivered item or items, delivery or performance of the undelivered item or items is considered probable and substantially within the entity's control. In contrast, the new revenue standard requires an entity 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, 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.

The identification of performance obligations is critical to the recognition of revenue because entities will use performance obligations as a means to measure the progress of satisfying the transfer of control of the goods or services. However, such identification will require judgment and will sometimes be time-consuming and complex.

Entities that question whether they can skip the process of identifying performance obligations in contracts should consider the Q&A below.

Q&A 5-4 Determining Whether Unbundling Is Optional

Step 2 of the revenue recognition model in ASC 606 requires an entity to assess the goods or services promised in a contract with a customer to identify the performance obligations in the contract. This process is sometimes referred to as "unbundling."

Question

Is unbundling optional?

Answer

No. Proper identification of the performance obligations in a contract is a critical aspect of the core principle of ASC 606, which is to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." Failure to identify and account for the separate performance obligations in a contract could result in the incorrect timing of revenue recognition.

As a practical matter, it may not be necessary to apply the detailed requirements in ASC 606 on unbundling if the amounts recognized and disclosed in the financial statements will be the same irrespective of whether unbundling is applied. For example, when control of two or more goods or two or more services is transferred at exactly the same time, or on the same basis over the same period of time, and if those items do not need to be segregated for disclosure purposes, then it will not be necessary to unbundle each of those concurrently delivered items because the amount and timing of revenue recognized and disclosed under the model would not differ if the items were unbundled.

5.3.2 Criteria to Be Distinct

ASC 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 promise to transfer the good or service is distinct within the context of the contract).

ASC 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.

To be a performance obligation, a promised good or service must be both (1) capable of being distinct and (2) distinct within the context of the contract. Early in the development of the new revenue standard, the FASB and IASB thought that goods and services should have a distinct function.[4] Entities asked for further explanation of what that meant. Accordingly, the boards provided the guidance in ASC 606-10-25-19(a) and (b) (paragraph 27(a) and (b) of IFRS 15).

Not all promises individually will meet both of these criteria. Under ASC 606-10-25-22, if an entity assesses a promise and determines that the promise does not meet the criteria, the entity is required to combine the promise with other promised goods and services in the contract until the criteria are met.

Cases A, B, and C of Example 10 in ASC 606, which are reproduced below, illustrate how an entity should combine the promises in a contract until those promises meet the criteria to be a performance obligation.

[4] See paragraph BC98 of ASU 2014-09.

ASC 606-10

Example 10 — Goods and Services Are Not Distinct

Case A — Significant Integration Service

55-137 An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

55-138 The promised goods and services are capable of being distinct in accordance with paragraph 606-10-25-19(a). That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.

55-139 However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

55-140 Because both criteria in paragraph 606-10-25-19 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

Case B — Significant Integration Service

55-140A An entity enters into a contract with a customer that will result in the delivery of multiple units of a highly complex, specialized device. The terms of the contract require the entity to establish a manufacturing process in order to produce the contracted units. The specifications are unique to the customer based on a custom design that is owned by the customer and that were developed under the terms of a separate contract that is not part of the current negotiated exchange. The entity is responsible for the overall management of the contract, which requires the performance and integration of various activities including procurement of materials; identifying and managing subcontractors; and performing manufacturing, assembly, and testing.

55-140B The entity assesses the promises in the contract and determines that each of the promised devices is capable of being distinct in accordance with paragraph 606-10-25-19(a) because the customer can benefit from each device on its own. This is because each unit can function independently of the other units.

55-140C The entity observes that the nature of its promise is to establish and provide a service of producing the full complement of devices for which the customer has contracted in accordance with the customer's specifications. The entity considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output) and, therefore, the devices and the various promised goods and services inherent in producing those devices are not separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. In this Case, the manufacturing process provided by the entity is specific to its contract with the customer. In addition, the nature of the entity's performance and, in particular, the significant integration service of the various activities mean that a change in one of the entity's activities to produce the devices has a significant effect on the other activities required to produce the highly complex specialized devices such that the entity's activities are highly interdependent and highly interrelated. Because the criterion in paragraph 606-10-25-19(b) is not met, the goods and services that will be provided by the entity are not separately identifiable, and, therefore, are not distinct. The entity accounts for all of the goods and services promised in the contract as a single performance obligation.

ASC 606-10 (continued)

Case C — Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

5.3.2.1 Capable of Being Distinct

The first criterion in ASC 606-10-25-19 that must be met for a promised good or service to be distinct (i.e., the good or service is capable of being distinct) is expanded in ASC 606-10-25-20:

ASC 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.

As noted in paragraph BC99 of ASU 2014-09, the FASB and IASB determined that the first criterion for assessing whether goods or services in a contract are distinct would require an entity to assess whether a customer could economically benefit from the goods or services on their own or together with other readily available resources. "Readily available resources" could be those that have already been transferred to the customer as part of the current contract or prior contracts. The fact that a good or service is typically sold on its own is an indicator that the good or service meets the first criterion.

In paragraph BC97 of ASU 2014-09, the FASB and IASB describe an arrangement that fails the "capable of being distinct" criterion. Specifically, the boards state that if an entity transfers control of a machine to a customer, but the machine will not provide an economic benefit to the customer without installation that only the entity can perform, the machine is not distinct.

Application of the "capable of being distinct" criterion is further illustrated in Example 56, Case A, of the new revenue standard. In that example, which is reproduced in Section 11.3, an entity determines that a pharmaceutical patent license is not distinct from the entity's promise to manufacture the drug for the customer because the customer cannot benefit from the license without the corresponding manufacturing service.

The assessment of whether the customer can economically benefit from the goods or services on its own should not be based on the customer's intended use of the goods or services. As stated in paragraph BC101 of ASU 2014-09, the FASB and IASB "observed that it would be difficult, if not impossible, for an entity to know the customer's intentions in a given contract." Accordingly, paragraph BC100 of ASU 2014-09 notes that the assessment of whether the customer can benefit from the goods or services on its own "should be based on the characteristics of the promised 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."

The "capable of being distinct" criterion is similar to the criterion in current guidance on multiple-element arrangements that requires a deliverable to have "value to the customer on a standalone basis" to be considered a separate unit of accounting. However, paragraph BC101 of ASU 2014-09 notes that the FASB and IASB made a conscious decision not to use the same language in the new revenue standard to avoid implying that an entity must assess the customer's intentions for the promised goods or services.

However, paragraph BC102 of ASU 2014-09 indicates that in developing the new revenue standard, the FASB and IASB determined that it may be impractical to separate every promised good or service that is capable of being distinct. More importantly, the boards noted that doing so could produce outcomes that (1) are not decision-useful and (2) do not faithfully represent an entity's performance related to delivering on its promises in a contract. A simple example to illustrate this notion is a construction-type contract in which an entity transfers to a customer multiple goods or services — such as raw materials and construction labor services — that are capable of being distinct. Separating, measuring, and recognizing revenue for each of these goods or services would result in the recognition of revenue when the materials and other services are provided instead of as the entity performs by using the materials to construct an item promised to the customer and for which the customer ultimately contracted.

Accordingly, the FASB and IASB developed a second criterion that must also be met for a promised good or service to be distinct. Specifically, under ASC 606-10-25-19(b) (paragraph 27(b) of IFRS 15), the promised good or service must be distinct within the context of the contract.

5.3.2.2 Distinct Within the Context of the Contract

ASC 606-10

25-21 In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

a. The entity provides a significant service of integrating [the] goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.

b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.

c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

As indicated in ASC 606-10-25-19(b), the second criterion that must be met for a promise to be a performance obligation is that the good or service is distinct within the context of the contract. The FASB and IASB decided to include this criterion because there could be situations in which a good or service is typically sold on its own and therefore is capable of being distinct, but the entity's contract with the customer requires the entity to provide additional goods and services and what the customer is actually acquiring is the combined goods or services (e.g., as in the construction-type contract noted in Section 5.3.2.1). Accordingly, the entity should combine the goods and services so that it can recognize revenue associated with the performance obligation in a way that truly depicts the transfer of control of the promised goods and services.

The second separation criterion does not exist in current U.S. GAAP and introduces a different framework for evaluating the separation of elements in an arrangement. As discussed in paragraph BC103 of ASU 2014-09, the second separation criterion was developed 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." Observing that the concept of separable risks was not well understood by stakeholders, the boards indicated that the objective of the second criterion is to evaluate whether an entity's promise to transfer a good or service is "separately identifiable" from other promises in the contract. However, this framework was also not well understood, and stakeholders requested that the FASB provide additional guidance on the second criterion to clarify when a promise is separately identifiable. As a result, the FASB issued ASU 2016-10, which clarifies the intent of the "separately identifiable" principle in ASC 606-10-25-21 by providing, in a manner consistent with the notion of separable risks, what the ASU describes as "three factors that indicate that an entity's promises to transfer goods or services to a customer are not separately identifiable." Accordingly, the focus is now on the bundle of goods or services instead of individual goods or services.

An example of the factor in ASC 606-10-25-21(a) is a construction contract to build a house (as noted in Section 5.3.2.1). The contract will require the entity to provide the materials and labor needed to build the house. However, identifying all items that are capable of being distinct, such as wood or cement, would not represent the entity's true obligation because the customer is not purchasing those items individually. Rather, the customer contracted with the entity to purchase a house. Therefore, it would make more sense to identify the performance obligation as the entity's overall promise to build a house.

An example of the factor in ASC 606-10-25-21(b) is a software contract in which the entity promises to customize software for the customer (see paragraphs BC109 and BC110 of ASU 2014-09). In determining how many performance obligations exist, the entity would have to consider whether the customer would really benefit from the software without the customization.

The factor in ASC 606-10-25-21(c) is illustrated by a third scenario described in ASU 2014-09, in which an entity designs and manufactures a new experimental product for a customer (see paragraphs BC111 and BC112 of ASU 2014-09). The entity expects that as it develops the product, it will have to make many revisions to the product to meet the customer's needs. The entity also expects the manufacturing process to affect the product's design because the entity will need to determine how to manufacture the product for the customer. Since both the design and manufacturing of the product are necessary to satisfy the contract with the customer and neither process alone will provide the customer with a product that it can use, both processes would be combined and treated as one performance obligation.

5.3.2.3 Applying the "Distinct" Criteria

Now that the concepts have been established, the examples below will help illustrate how to apply them in different situations.

ASC 606-10

Example 11 — Determining Whether Goods or Services Are Distinct

Case A — Distinct Goods or Services

55-141 An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

55-142 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

ASC 606-10 (continued)

55-143 The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In reaching this determination the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because, in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

55-144 On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

a. The software license
b. An installation service
c. Software updates
d. Technical support.

55-145 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software license in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A (see Example 54 in paragraphs 606-10-55-362 through 55-363B).

Case B — Significant Customization

55-146 The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

55-147 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

55-148 On the basis of the same [analysis] as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

ASC 606-10 (continued)

55-149 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization which is comprised of the license to the software and the customized installation service
b. Software updates
c. Technical support.

55-150 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

Case C — Promises Are Separately Identifiable (Installation)

55-150A An entity contracts with a customer to sell a piece of equipment and installation services. The equipment is operational without any customization or modification. The installation required is not complex and is capable of being performed by several alternative service providers.

55-150B The entity identifies two promised goods and services in the contract: (a) equipment and (b) installation. The entity assesses the criteria in paragraph 606-10-25-19 to determine whether each promised good or service is distinct. The entity determines that the equipment and the installation each meet the criterion in paragraph 606-10-25-19(a). The customer can benefit from the equipment on its own, by using it or reselling it for an amount greater than scrap value, or together with other readily available resources (for example, installation services available from alternative providers). The customer also can benefit from the installation services together with other resources that the customer will already have obtained from the entity (that is, the equipment).

55-150C The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (in accordance with paragraph 606-10-25-19(b)). The entity considers the principle and 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. In this Case, each of the factors in paragraph 606-10-25-21 contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable as follows:

a. The entity is not providing a significant integration service. That is, the entity has promised to deliver the equipment and then install it; the entity would be able to fulfill its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.
b. The entity's installation services will not significantly customize or significantly modify the equipment.
c. Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfill its promise to transfer the equipment independently of its promise to provide the installation services. Because the equipment and the installation services do not each significantly affect the other, they are not highly interdependent or highly interrelated.

On the basis of this assessment, the entity identifies two performance obligations (the equipment and installation services) in the contract.

55-150D The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

ASC 606-10 (continued)

Case D — Promises Are Separately Identifiable (Contractual Restrictions)

55-150E Assume the same facts as in Case C, except that the customer is contractually required to use the entity's installation services.

55-150F The contractual requirement to use the entity's installation services does not change the evaluation of whether the promised goods and services are distinct in this Case. This is because the contractual requirement to use the entity's installation services does not change the characteristics of the goods or services themselves, nor does it change the entity's promises to the customer. Although the customer is required to use the entity's installation services, the equipment and the installation services are capable of being distinct (that is, they each meet the criterion in paragraph 606-10-25-19(a)), and the entity's promises to provide the equipment and to provide the installation services are each separately identifiable (that is, they each meet the criterion in paragraph 606-10-25-19(b)). The entity's analysis in this regard is consistent with Case C.

Case E — Promises Are Separately Identifiable (Consumables)

55-150G An entity enters into a contract with a customer to provide a piece of off-the-shelf equipment (that is, it is operational without any significant customization or modification) and to provide specialized consumables for use in the equipment at predetermined intervals over the next three years. The consumables are produced only by the entity, but are sold separately by the entity.

55-150H The entity determines that the customer can benefit from the equipment together with the readily available consumables. The consumables are readily available in accordance with paragraph 606-10-25-20 because they are regularly sold separately by the entity (that is, through refill orders to customers that previously purchased the equipment). The customer can benefit from the consumables that will be delivered under the contract together with the delivered equipment that is transferred to the customer initially under the contract. Therefore, the equipment and the consumables are each capable of being distinct in accordance with paragraph 606-10-25-19(a).

55-150I The entity determines that its promises to transfer the equipment and to provide consumables over a three-year period are each separately identifiable in accordance with paragraph 606-10-25-19(b). In determining that the equipment and the consumables are not inputs to a combined item in this contract, the entity considers that it is not providing a significant integration service that transforms the equipment and consumables into a combined output. Additionally, neither the equipment nor the consumables are significantly customized or modified by the other. Lastly, the entity concludes that the equipment and the consumables are not highly interdependent or highly interrelated because they do not significantly affect each other. Although the customer can benefit from the consumables in this contract only after it has obtained control of the equipment (that is, the consumables would have no use without the equipment) and the consumables are required for the equipment to function, the equipment and the consumables do not each significantly affect the other. This is because the entity would be able to fulfill each of its promises in the contract independently of the other. That is, the entity would be able to fulfill its promise to transfer the equipment even if the customer did not purchase any consumables and would be able to fulfill its promise to provide the consumables even if the customer acquired the equipment separately.

55-150J On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

a. The equipment
b. The consumables.

55-150K The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

5.3.3 Series Guidance

As previously mentioned, ASC 606-10-25-14 describes what a performance obligation is. ASC 606-10-25-14(b) explains that a performance obligation can be a series of goods or services; however, the performance obligation must meet some requirements to qualify as a series. Specifically, the goods or services must have substantially the same pattern of transfer to the customer as though they were a single performance obligation. As explained in paragraph BC113 of ASU 2014-09, the FASB and IASB came to this conclusion to provide the series guidance because it would promote consistent application of the new revenue standard across similar goods and services.

To clarify the meaning of "the same pattern of transfer," the boards provided the following guidance in ASC 606-10-25-15 (paragraph 23 of IFRS 15):

ASC 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 [see Section 8.4].

b. In accordance with paragraphs 606-10-25-31 through 25-32 [see Section 8.5], 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.

The Q&A below illustrates how to determine whether a promise in a contract is for the delivery of a series of distinct goods or services.

Some entities may find it preferable to account for goods and services individually instead of as a series even though the goods and services meet the requirements of the series guidance. The Q&A below discusses whether the series guidance is optional.

Q&A 5-5 Mandatory Treatment of a Series of Distinct Goods or Services as a Single Performance Obligation

Question

If an entity concludes that a series of distinct goods or services meets the requirements of ASC 606-10-25-14(b), is it required to treat that series as a single performance obligation or may it choose to regard the distinct goods or services in the series as individual performance obligations?

Answer

An entity that reaches this conclusion is required to account for the series of goods or services as a single performance obligation. Paragraph BC113 of ASU 2014-09 clarifies the boards' intent to mandate the use of this simplification, stating that they "decided to specify that a promise to transfer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer **would be a single performance obligation** if two criteria are met" (emphasis added).

TRG Update — Series of Distinct Goods and Services

In discussion with the TRG, the FASB and IASB staffs noted that an entity may determine that goods and services constitute a single performance obligation if (1) they are "bundled" together because they are not distinct or (2) they are distinct but meet the criteria that require the entity to account for them as a series (and thus as a single performance obligation). The staffs further noted that a single performance obligation that comprises a series of distinct goods or services rather than a bundle of goods or services that are not distinct affects (1) how variable consideration is allocated, (2) whether contract modifications are accounted for on a cumulative catch-up or prospective basis, and (3) how changes in the transaction price are treated. Because of the potential implications associated with whether goods or services are determined to be a series, stakeholders have raised questions about:

- *Whether goods must be delivered (or services must be performed) consecutively for an entity to apply the series provision* — The staffs indicated that an entity should look to the series provision criteria in ASC 606-10-25-15 to determine whether the goods or services are a series of distinct goods or services for which the entity is not explicitly required to identify a consecutive pattern of performance. Further, while the term "consecutively" is used in the Basis for Conclusions of ASU 2014-09, the staffs noted that they "do not think whether or not the pattern of performance is consecutive is determinative [of] whether the series provision applies."[5] That is, goods or services do not need to be transferred consecutively to qualify as a series of distinct goods or services under the new revenue standard.
- *Whether the accounting result for the series of distinct goods or services as a single performance obligation needs to be the same as if each underlying good or service were accounted for as a separate performance obligation* — The staffs noted that they do not believe that the accounting result needs to be "substantially the same." Further, the staffs stated that "[s]uch a requirement would almost certainly make it more difficult for entities to meet the requirement, and since the series provision is not optional, it likely would *require* entities to undertake a 'with and without' type analysis in a large number of circumstances to prove whether the series provision applies or not."[6]

The Q&As below reflect the staffs' views as discussed at the March 30, 2015, TRG meeting.

Q&A 5-6 Applying the Series Provision When the Pattern of Transfer Is Not Consecutive

A series of goods or services will often be transferred consecutively (e.g., under a contract to provide the same package of cleaning services each consecutive week for 52 weeks). However, sometimes the series of goods or services will not be delivered each week on a consecutive basis (e.g., under a cleaning contract in which services are not provided in certain weeks but are provided in other weeks on an overlapping basis whereby cleaning begins before the previous week's work has been completed).

Question

For an entity to determine that the series requirement in ASC 606-10-25-14(b) is met and, specifically, that goods or services have the "same pattern of transfer to the customer," must the goods or services be transferred consecutively?

[5] Quoted from paragraph 14 of TRG Agenda Paper 27.
[6] Quoted from paragraph 20 of TRG Agenda Paper 27.

Answer

No. The series requirement is intended to simplify the application of the revenue model in ASC 606 and to promote consistency in the identification of performance obligations. In certain instances, it requires identification of a single performance obligation even though the underlying goods and services are distinct (i.e., when distinct goods or services are provided in a series). ASC 606-10-25-15 sets out the two criteria that must be met for an entity to conclude that a series of two or more goods or services is a single performance obligation:

- "Each distinct good or service . . . would meet the criteria . . . to be a performance obligation satisfied over time," in accordance with ASC 606-10-25-27.
- The "same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation," in accordance with ASC 606-10-25-31 and 25-32.

Neither of these criteria refers to the consecutive transfer of goods or services to the customer, and both criteria could be met in each of the cleaning contract examples described above. Therefore, the applicability of ASC 606-10-25-14(b) does not depend on whether the goods (services) will be consecutively delivered (performed).

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 5-7 Determining Whether a Promise to Transfer Goods or Services Constitutes a Series of Distinct Goods or Services That Are Substantially the Same

ASC 606-10-25-14 states:

> 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). [Emphasis added]

Note that the requirement above for the same pattern of transfer includes, among other things, that control is transferred over time.

As explained in paragraph BC113 of ASU 2014-09, ASC 606-10-25-14(b) (the "series provision") is intended to "simplify the application of the model . . . in circumstances in which the entity provides the same good or service consecutively over a period of time (for example, a repetitive service arrangement)." Further, the ASU's Basis for Conclusions indicates that without the series provision, an entity could encounter operational challenges in managing numerous performance obligations and allocating the transaction price to those performance obligations on a stand-alone selling price basis.

Question

For distinct goods or services to be considered *substantially the same* to be accounted for as a series under ASC 606-10-25-14(b), does each increment of distinct goods or services provided to the customer need to be identical?

Answer

No, it is not necessary for each increment of distinct goods or services to be identical. Instead, it is necessary to evaluate whether there is a series of distinct goods or services that are substantially the same.

The evaluation of whether distinct goods or services are substantially the same requires significant judgment based on the relevant facts and circumstances of the contract.

An entity should first determine the nature of the promised goods or services to be provided under the contract by evaluating whether the nature of the arrangement is to provide the customer with a specified quantity of distinct goods or services or to stand ready to provide an undefined quantity of goods or services over the duration of the contract period.

Specified Quantity of Distinct Goods or Services

Generally, arrangements to deliver a specified quantity of similar goods or services result in repetitive delivery of the goods or services. An entity should evaluate whether each repetitive good or service is substantially the same as the others. Consider the following example:

Example 1

Monthly Payroll Services

Company A provides Customer Z monthly payroll processing services for one year. Company A concludes that each monthly service (1) is distinct, (2) meets the criteria for recognizing revenue over time, and (3) has the same method for measuring progress. In addition, A concludes that the services of processing payroll each month are substantially the same and result in the transfer of substantially the same service (payroll processing) to the customer each month. That is, the benefit consumed by the customer is substantially the same for each monthly transaction, even though the exact volume of employee payroll processed may vary each month. Therefore, A concludes that the monthly payroll services satisfy the requirements of ASC 606-10-25-14(b) to be accounted for as a single performance obligation.

Undefined Services Over the Contract Period

A contract may require an entity to perform various activities as part of transferring services over the contract period. In these circumstances, an entity would need to determine whether the nature of the promise is to provide the customer with (1) multiple different services or (2) one integrated service (with different activities). In making this determination, an entity might first determine the nature of the services by evaluating the benefit provided to the customer. If the entity determines that the customer benefits from the integrated service over the contract term, it should then evaluate whether each time increment (e.g., hour, day, or week) is substantially the same. In these situations, each time increment of service may be substantially the same even if the underlying activities differ. Consider the following examples:

Example 2

Hotel Management Services

Company B provides hotel management services to Customer Y that include hiring and managing employees, procuring goods and services, and advertising and marketing the hotel. In a given day, B could clean guest rooms, perform marketing efforts to increase occupancy, and operate the concierge desk.

Company B concludes that the nature of the contract is to provide integrated hotel management services over the term of the contract and not a specific quantity of specified services (e.g., cleaning 100 guest rooms per day). The underlying activities in providing the hotel management services can vary significantly from day to day; however, the daily services are activities that are required to satisfy B's obligation to provide an integrated hotel management service. Therefore, the integrated service of hotel management transferred to the customer is substantially the same during each period. That is, Y receives substantially the same benefit each period.

Company B concludes that each increment of service (i.e., day or week) is distinct, meets the criteria for recognizing revenue over time, and has the same method for measuring progress. Therefore, B would conclude that the hotel management services satisfy the requirements of ASC 606-10-25-14(b) to be accounted for as a single performance obligation.

Example 3

IT Outsourcing Services

Company C provides IT outsourcing services to Customer X for a five-year period. The IT outsourcing services include providing X with server capacity, maintenance of the customer's software portfolio, and access to an IT help desk.

Company C considers the nature of the promise to X. Company C concludes that its promise to X is to provide continuous access to an integrated outsourced IT solution and not to provide a specified quantity of services (e.g., processing 100 transactions per day). The underlying activities in providing IT outsourcing services can vary significantly from day to day; however, the daily services are activities performed to fulfill C's integrated IT outsourcing service and are substantially the same. Company C concludes that for each period, (1) C is providing an integrated IT outsourcing service; (2) the customer is continuously receiving substantially the same benefit, which is distinct; and (3) each increment of time is substantially the same (i.e., each increment provides the same integrated IT outsourcing solution).

Company C concludes that each distinct increment of time meets the criteria for recognizing revenue over time and has the same method for measuring progress. Therefore, C concludes that the IT outsourcing services satisfy the requirements of ASC 606-10-25-14(b) to be accounted for as a single performance obligation.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 5-8 Whether Treating Distinct Goods or Services as a Series Under ASC 606-10-25-14(b) Must Produce the Same Accounting Result as Treating Each Distinct Good or Service as a Separate Performance Obligation

ASC 606-10-25-14(b) requires an entity to treat a "series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer" as a single performance obligation (see Q&A 5-5). ASC 606-10-25-15 specifies the criteria that must be met for an entity to conclude that a series of distinct goods or services has the same pattern of transfer to the customer.

Question

Must the application of ASC 606-10-25-14(b) produce the same accounting result as treating each distinct good or service as a separate performance obligation?

Answer

No. ASC 606 does not impose any such requirement.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

5.4 Defining the Nature of the Promise

5.4.1 In General

As previously discussed, performance obligations can vary greatly across industries, within industries, and even within a company. An entity must assess its contracts with customers to determine what performance obligations it needs to satisfy. Once it completes this task, the entity will have to determine the appropriate pattern of satisfaction of the performance obligations (see Chapter 8 for discussion of step 5). As noted in paragraph BC159 of ASU 2014-09, an entity does not have a "free choice" in determining the appropriate method for measuring progress toward satisfaction of the performance obligations; rather, the entity should use judgment to choose a measurement method that represents the pattern of satisfaction of the performance obligation. To accomplish this, the entity should assess the nature of the promises in its performance obligations (i.e., consider how and when it will satisfy its performance obligations).

5.4.2 Stand-Ready Obligations

Contracts promise specific goods and services, but sometimes they also promise to deliver those goods and services over a specified period. When an entity enters into a contract with a customer and agrees to make itself available to provide goods and services to the customer over a specified period, such a promise is generally viewed as a stand-ready obligation. Typically in this type of arrangement, a customer would make requests of the entity to deliver some or all of the goods and services at some point during the period defined in the contract.

Many questions have been asked about stand-ready obligations. Consider the TRG Update and related Q&As below.

TRG Update — Stand-Ready Obligations

The TRG discussed stand-ready obligations because of the concerns and questions that stakeholders have raised. Stakeholders have identified four broad types of promises or arrangements that may constitute stand-ready obligations, including those for which the obligation to deliver goods or services is:

- Within the entity's control, but for which additional development of the goods, services, or intellectual property is required ("Type A").
- Outside both the entity's and customer's control ("Type B").
- Solely within the customer's control ("Type C").

The fourth category identified is promises to make an entity's goods or services available to the customer continuously over the contractual period — such as a health club membership, which is the only example of a stand-ready obligation in the new revenue standard[7] ("Type D"). A potential way to account for a Type D arrangement is for the entity to record revenue ratably over the performance period on a straight-line basis. Straight-line revenue recognition results because (1) the customer is required to pay regardless of how frequently he or she uses the health club and (2) the entity stands ready to makes its goods or services available to the customer on a constant basis over the contract period.

Because the new revenue standard provides an example of Type D arrangements but not others, questions have arisen regarding the identification of other stand-ready obligations (i.e., Types A through C) and how to appropriately measure progress toward completion of delivering the promised goods or services. Specifically, views differ on (1) what constitutes the nature of the promise in the aforementioned arrangements (e.g., whether it is the act of standing ready or the actual delivery of the goods or services to the customer) and (2) the methods used to measure progress toward the complete satisfaction of a stand-ready obligation (e.g., a time-based, input, or output method).

Q&A 5-9 Assessing Whether a Promise Is a Stand-Ready Performance Obligation

ASC 606-10-25-18 lists types of promises in a contract that an entity should assess to determine whether they are distinct performance obligations. For example, ASC 606-10-25-18(e) describes a service of "standing ready" to provide goods or services ("stand-ready obligation"). The customer receives and consumes a benefit from a stand-ready obligation — namely, the assurance that a service or scarce resource (e.g., snow removal during the winter) is available to the customer when and if needed or called upon.

Question

What should an entity consider in determining whether a promise is a stand-ready obligation?

Answer

Distinguishing a performance obligation to deliver goods or services from a stand-ready obligation to deliver goods or services may be complex and will require an entity to consider the arrangement's relevant facts and circumstances. However, an entity should begin by identifying the nature of the promise in the contract. For example, the determination of whether the promise is an obligation to provide one or more defined goods or services or is instead

[7] ASC 606-10-55-184 through 55-186.

an obligation to provide an unknown type or quantity of goods or services **might** be a strong indicator of the nature of the entity's promise in the contract. While in *either* case the entity might be required to "stand ready" to deliver the good(s) or service(s) whenever called for by the customer or upon the occurrence of a contingent event (e.g., snowfall), the fact that the entity will not know when or how extensively the customer will receive the entity's good(s) or service(s) during the contract term may be a strong indicator that the entity is standing ready to perform.

Example 18 in ASC 606-10-55-184 through 55-186 discusses stand-ready obligations in health club memberships. The example notes that the entity's promise is to provide a service of making the health clubs available because the extent to which a customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. This is consistent with the discussion in paragraph BC160 of ASU 2014-09.

Other examples of stand-ready performance obligations may include the following:

- *Snow removal services* — An entity promises to remove snow on an "as needed" basis. In this type of arrangement, the entity does not know and most likely cannot reasonably estimate whether, how often, and how much it will snow. This suggests that the entity's promise is to stand ready to provide these services on a when-and-if-needed basis.
- *Software upgrades* — An entity promises to make unspecified (i.e., when-and-if-available) software upgrades available to a customer, and the entity has no discernible pattern of providing updates. The nature of the entity's promise is fundamentally one of providing the customer with assurance that any upgrades or updates developed by the entity during the period will be made available because the entity stands ready to transfer updates or upgrades when and if they become available.
- *Extended warranty* — A customer purchases an extended product warranty for a good (e.g., equipment), and the entity promises to remediate **any** issues with the product when and if problems arise. That is, the entity is standing ready to make repairs when and if needed.

See Q&A 8-17 for additional considerations on measuring progress toward the complete satisfaction of a stand-ready obligation that is satisfied over time.

The TRG discussed this issue in January 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 25. For additional information and Deloitte's summary, see Appendixes D and E.

There can be situations in which the contract with a customer is not specific about what is promised to a customer. This type of contract could appear to be a stand-ready obligation. The Q&A below provides an example of this situation and how to determine whether an entity's promise is a stand-ready obligation.

Q&A 5-10 Unspecified Future Goods or Services in a Software Arrangement — Timing of Revenue Recognition

An entity may enter into a contract with a customer that includes two performance obligations (1) a license of software and (2) a promise to provide unspecified[8] upgrades to the software on a "when and if available" basis. The unspecified upgrades are different from, and extend beyond, an assurance-type warranty.

[8] The nature of the entity's promise when it commits to provide unspecified upgrades to a customer differs from the entity's obligation when it commits to deliver specified upgrades. This Q&A addresses only unspecified upgrades. For specified upgrades, the answer will most likely be different since specified upgrades will often be a separate performance obligation.

Question

How should an entity recognize revenue for a promise to provide unspecified upgrades to the software?

Answer

When a contract with a customer transfers the rights to unspecified future upgrades or products, an entity is required to use judgment to determine whether the nature of the promise (performance obligation) is either of the following:

- To stand ready to maintain or enhance the software as needed.
- To develop and provide a new or significantly enhanced version of the software.

If the nature of the promise represents an obligation by the entity to stand ready to maintain or enhance the software as needed to ensure that the customer can continue to receive and consume the benefit of the software throughout the contract term, the value to the customer is transferred over time as the entity stands ready to perform. That is, the entity would (1) satisfy the performance obligation over time and (2) determine the appropriate measure of progress to recognize revenue over time.

If the nature of the promise represents an implied obligation to develop and provide new or significantly enhanced versions of the software through upgrades, the benefits of those upgrades are received and consumed when and if they are made available to the customer. That is, the performance obligation is only satisfied at the individual points in time when those upgrades are delivered to the customer.

Alternatively, there can be situations in which the entity must differentiate between a promise to stand ready to deliver goods or services to the customer and a promise to deliver a defined amount of goods or services. The Q&A below provides an example of this situation and how to determine whether the promise is a stand-ready obligation.

Q&A 5-11 Determining Whether a Contract Includes a Stand-Ready Obligation or an Obligation to Provide a Defined Amount of Goods or Services

It will sometimes be necessary to determine whether the nature of an entity's promise under a contract is (1) to stand ready to provide goods or services or (2) to provide a defined amount of discrete goods or services. A promise to stand ready to provide goods or services is often satisfied over time as the customer benefits from being able to call upon a resource if and when needed throughout the stand-ready obligation period. However, an obligation to provide a defined amount of discrete goods or services is satisfied when or as those discrete goods or services are transferred to the customer.

Question

How should an entity determine the nature of its promise under a contract to distinguish between a stand-ready obligation and an obligation to provide a defined amount of goods or services?

Answer

An entity may be required to use judgment to distinguish between a stand-ready obligation and an obligation to provide a defined amount of goods or services. It will often be helpful for an entity to focus on the extent to which a customer's use of a resource affects the remaining resources to which the customer is entitled. A determination that the nature of the entity's obligation to the customer is to provide resources as and when required by the customer and that the customer's future entitlement is unaffected by the extent to which resources have already been provided is indicative of a stand-ready obligation. In contrast, a determination that the contract is to supply a specified number of units of the resource and that the remaining entitlement diminishes as each unit is consumed is indicative of an obligation to provide a defined amount of goods or services.

Paragraph BC160 of ASU 2014-09 discusses the concept of a stand-ready obligation as follows:

> To meet [the] 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. [Emphasis added]

Example

Company X enters into a software arrangement with Customer Y, who pays up-front nonrefundable consideration in exchange for a software license and a specified quantity of service credits. The credits can be redeemed for consulting services as and when needed by the customer over a three-year term.

Each credit is equivalent to a predetermined number of consulting hours. The agreement requires X to be available to provide consulting services in exchange for credits when requested by Y. The credits expire after the three-year term; however, customers generally use all of their credits.

As discussed above, for an entity to distinguish between a stand-ready obligation and an obligation to provide a defined amount of goods or services, it will often be helpful to focus on the extent to which the customer's use of a resource affects the remaining resources to which the customer is entitled.

In the circumstances described, Y pays in advance for a defined amount of consulting services to be provided by X when and if needed by Y. In contrast to the example in paragraph BC160 of ASU 2014-09, when Y redeems credits for consulting services, this does affect the amount of the remaining services to which it is entitled, indicating that X's promise is to deliver specified services rather than to stand ready.

In this example, assuming that X does not expect to be entitled to breakage, X should recognize revenue as the consulting services are provided to Y for redeemed credits or when the credits expire at the end of the three-year arrangement.

However, if X's obligation was to provide an unspecified amount of consulting services over time (e.g., an obligation to provide whatever level of consulting services was needed by Y), a different revenue recognition pattern would most likely result because X's promise would be to stand ready. In this scenario, Y's entitlement to future consulting services would not be affected by the extent to which Y had already received consulting services.

See Q&A 8-18 for an additional illustration of this distinction.

5.5 Warranties

5.5.1 In General

Early in the drafting of the new revenue standard, the FASB and IASB thought to treat all warranties similarly because generally, all warranties represent an entity's promise to stand ready to repair or replace the good or service the entity has provided to a customer in accordance with the terms of the parties' contract. However, stakeholders informed the boards that some warranties are different from others and that entities should account for such warranties differently. The boards agreed with the stakeholders' feedback.

5.5.2 Types of Warranties

ASC 606-10

55-30 It is common for an entity to provide (in accordance with the contract, the law, or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

It is important to determine what type of warranty an entity offers to a customer because the way in which revenue is recognized will vary depending on that determination. An entity should determine whether it offers the customer an assurance-type warranty or a service-type warranty. An assurance-type warranty provides the customer with the peace of mind that the entity will fix or possibly replace a good or service if the original good or service was faulty. It is the type of warranty with which most customers are familiar. In contrast, a service-type warranty provides the customer with a service that is incremental to the assurance that the good or service will meet expectations agreed to in the contract.

5.5.3 Determining Whether a Warranty Is a Performance Obligation (Service-Type Warranties)

ASC 606-10

55-31 If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10

55-34 If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

55-35 A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products does not give rise to a performance obligation. The entity should account for such obligations in accordance with the guidance on loss contingencies in Subtopic 450-20 on contingencies.

An entity will have to use judgment to determine whether a warranty is a service-type warranty (i.e., performance obligation). This is important because, depending on the outcome of the entity's assessment, consideration could be allocated to the performance obligation and consequently change the pattern of revenue recognition.

To assess the nature of a warranty, an entity should consider whether the warranty provides an additional service. An easy way to determine this is if a warranty is sold separately. As discussed in paragraph BC371 of ASU 2014-09, an entity could also separately negotiate a warranty with a customer and determine that a performance obligation exists.

However, a warranty does not necessarily have to be separately sold or separately negotiated to be considered a performance obligation. To determine whether a warranty is a performance obligation, an entity should consider various indicators in accordance with ASC 606-10-55-33.

ASC 606-10

55-33 In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

a. Whether the warranty is required by law — If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
b. The length of the warranty coverage period — The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
c. The nature of the tasks that the entity promises to perform — If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

This issue is further discussed in the Q&A below.

Q&A 5-12 Assessing Whether a Warranty Is a Separate Performance Obligation

ASC 606-10-55-31 states that "[i]f a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract."

Question

Is a warranty that is neither separately priced nor separately negotiated capable of being a separate performance obligation?

Answer

Yes. A warranty that provides a service **in addition** to the entity's assurance that the goods or services transferred to a customer will function as intended or meet agreed-upon specifications would represent a separate performance obligation. Accordingly, the entity would need to allocate a portion of the transaction price to the separate service and recognize the related revenue when (or as) performance is completed even when this warranty is neither separately priced nor separately negotiated.

If the warranty merely provides what ASC 606-10-55-30 describes as "assurance that the related product will function as the parties intended because it complies with agreed-upon specifications," the assurance is not a service and therefore not a separate performance obligation. In this situation, the costs associated with providing the warranty would be accrued in accordance with ASC 460-10 (see ASC 606-10-55-32).

Assessing the substance of the promise in a warranty arrangement that is neither separately priced nor separately negotiated often will require judgment. To aid in such an assessment, ASC 606-10-55-33 lists three factors that an entity should consider in determining whether a warranty provides the customer with a service in addition to the entity's assurance that the good or service complies with agreed-upon specifications: (1) whether the warranty is required by law, (2) the length of the coverage period, and (3) the nature of the tasks that are promised.

Example 1

In accordance with customary business practices, a luggage manufacturer provides all customers with a one-year warranty that covers only manufacturing defects.

This warranty does not represent a separate performance obligation because it only provides assurance that the luggage will function as intended over a short (and customary) period. This is an "assurance-type" warranty, which should be accounted for under ASC 460. As a result, there is no revenue deferral for the warranty.

Example 2

A luggage manufacturer provides all customers with a lifetime warranty that covers all defects and damages, including those arising from normal wear and tear.

This warranty represents a separate performance obligation because the manufacturer has agreed to provide repairs for all damage (i.e., it has agreed to provide a service of repairing the luggage for all damage, which extends beyond rectifying manufacturing defects) and over a longer period than is customary (i.e., the life of the luggage). The luggage manufacturer should (1) determine the stand-alone selling price of the repair service and allocate an appropriate portion of the transaction price to it and (2) recognize that portion as revenue over the period in which the service is delivered.

The TRG discussed these examples in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

TRG Update — Warranties

Questions continually arise about how an entity would determine whether a product warranty that is not separately priced is a performance obligation (i.e., whether the warranty represents a service rather than a guarantee of the product's intended functionality). For illustrative purposes, TRG members discussed an example in which a luggage company provides a lifetime warranty to repair any damage to the luggage free of charge and noted that such a warranty would be a separate performance obligation because the company agreed to repair **any** damage (i.e., repairs extend beyond those that fix defects preventing the luggage from functioning as intended).

TRG members generally agreed with the conclusion that the warranty in the luggage example would represent a separate performance obligation but that it "illustrates a relatively [straightforward] set of facts and circumstances that demonstrate an instance of when a warranty provides a service."[9] However, the conclusion for other warranty arrangements may be less clear. Accordingly, an entity will need to assess the substance of the promises in a warranty arrangement and exercise judgment on the basis of the entity's specific facts and circumstances.

In addition, while the duration of the warranty (e.g., the lifetime warranty in the luggage company example discussed) may be an indicator of whether a warranty is a separate performance obligation, it is not determinative. For an illustration of this view, consider the Q&A below.

Q&A 5-13 Implicit Warranty Beyond the Contractual Period

In addition to providing a warranty that guarantees that an entity's product or service complies with agreed-upon specifications for a specified period, entities in many industries may continue to provide warranty-type services (e.g., repairs) beyond the original specified period as part of their customary business practices. In accordance with ASC 606-10-55-34, if an entity's warranty, or part of its warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service represents a performance obligation.

Question

How should an entity account for a business practice of providing a warranty-type service (e.g., repairs) beyond the warranty period explicitly specified in a contract with a customer?

[9] Quoted from paragraph 28 of TRG Agenda Paper 29.

Answer

It depends. Regardless of whether the warranty services are explicitly promised in the contract for a specified period or are implied by customary business practices, the entity must assess whether the services to be provided represent an assurance-type warranty (which should be accounted for in accordance with ASC 460-10) or a promised service (in addition to the assurance that the product complies with agreed-upon specifications) in the contract. This assessment requires an analysis of the nature of (1) the products or services that are subject to the specific warranty and (2) any other products or services that are provided as part of the entity's customary business practice.

ASC 606-10-55-33 lists the following factors that an entity should consider when assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications:

> a. Whether the warranty is required by law — If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
>
> b. The length of the warranty coverage period — The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
>
> c. The nature of the tasks that the entity promises to perform — If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

Example

Entity X sells long-life LED lightbulbs to customers with a two-year contractual warranty period. Entity X also has a customary business practice of providing its customers with a replacement lightbulb free of charge if a defective lightbulb is returned within three years of the date of purchase.

In accordance with ASC 606-10-55-32 and ASC 606-10-55-34, the practice of replacement in the third year is not considered an additional service (i.e., it is not a separate performance obligation) and therefore should not be accounted for as a service-type warranty. Entity X concludes that the practice of replacement in the third year should be accounted for as an assurance-type warranty, and is not a separate performance obligation, because X is only guaranteeing that the lightbulb will function as intended. Therefore, X accounts for the warranty in accordance with ASC 460-10.

5.5.4 Warranties Within the Scope of Other Guidance (Assurance-Type Warranties)

Warranties could be within the scope of guidance outside the new revenue standard under certain circumstances. For example, warranties that are determined to be separate performance obligations in accordance with the guidance in ASC 606-10-55-30 through 55-35 might appear to be insurance contracts. However, such warranties would only be considered insurance contracts within the scope of applicable guidance in ASC 944 if they are directly issued by a third party. Further, a warranty could be within the scope of the guidance on guarantees in ASC 460-10, as explained in ASC 606-10-55-32:

ASC 606-10

55-32 If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

5.5.5 Illustrative Example in ASC 606

The new revenue standard includes the following illustrative example of accounting for a warranty:

ASC 606-10

Example 44 — Warranties

55-309 An entity, a manufacturer, provides its customer with a warranty with the purchase of a product. The warranty provides assurance that the product complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. The contract also provides the customer with the right to receive up to 20 hours of training services on how to operate the product at no additional cost. The training services will help the customer optimize its use of the product in a short time frame. Therefore, although the training services are only for 20 hours and are not essential to the customer's ability to use the product, the entity determines that the training services are material in the context of the contract on the basis of the facts and circumstances of the arrangement.

55-310 The entity assesses the goods and services in the contract to determine whether they are distinct and therefore give rise to separate performance obligations.

55-311 The product and training services are each capable of being distinct in accordance with paragraphs 606-10-25-19(a) and 606-10-25-20 because the customer can benefit from the product on its own without the training services and can benefit from the training services together with the product that already has been transferred by the entity. The entity regularly sells the product separately without the training services.

55-312 The entity next assesses whether its promises to transfer the product and to provide the training services are separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. The entity does not provide a significant service of integrating the training services with the product (see paragraph 606-10-25-21(a)). The training services and product do not significantly modify or customize each other (see paragraph 606-10-25-21(b)). The product and the training services are not highly interdependent or highly interrelated as described in paragraph 606-10-25-21(c). The entity would be able to fulfill its promise to transfer the product independent of its efforts to subsequently provide the training services and would be able to provide training services to any customer that previously acquired its product. Consequently, the entity concludes that its promise to transfer the product and its promise to provide training services are not inputs to a combined item and, therefore, are each separately identifiable.

55-313 The product and training services are each distinct in accordance with paragraph 606-10-25-19 and therefore give rise to two separate performance obligations.

55-314 Finally, the entity assesses the promise to provide a warranty and observes that the warranty provides the customer with the assurance that the product will function as intended for one year. The entity concludes, in accordance with paragraphs 606-10-55-30 through 55-35, that the warranty does not provide the customer with a good or service in addition to that assurance and, therefore, the entity does not account for it as a performance obligation. The entity accounts for the assurance-type warranty in accordance with the requirements on product warranties in Subtopic 460-10.

55-315 As a result, the entity allocates the transaction price to the two performance obligations (the product and the training services) and recognizes revenue when (or as) those performance obligations are satisfied.

5.6 Customer Options for Additional Goods or Services (Material Rights)

5.6.1 In General

ASC 606-10

55-41 Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services.

55-42 If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

55-43 If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.

An entity's contract with a customer may give the customer a choice of whether to purchase additional goods or services; such a choice is typically referred to as an option for additional goods or services. Entities are required to identify options for additional goods or services because in certain circumstances, such options can lead to performance obligations. As explained in paragraph BC386 of ASU 2014-09, the FASB and IASB realized that it could be difficult to differentiate between (1) an option for additional goods or services that was paid for by the customer and (2) a marketing or promotional offer for which the customer did not pay. The first type of option for additional goods or services would be identified as a performance obligation to which consideration must be allocated in accordance with step 4 (see Chapter 7) of the new revenue standard.

To help entities determine whether an option for additional goods or services is a performance obligation, the boards included the concept of a material right in the new revenue standard. If an entity determines that an option for additional goods and services is a material right, the option should be considered a performance obligation. However, an entity will need to use judgment to determine whether a material right exists.

The guidance in the new revenue standard describes a material right as an option that provides the customer an incremental discount beyond the discounts that are typically given. This concept of a material right stems from software revenue guidance under current U.S. GAAP in ASC 985-605, which provides that a deliverable in a contract should be accounted for separately if it is discounted by a significant and incremental amount with respect to both (1) that contract and (2) other similar contracts. However, a material right under the new guidance is slightly different in that the new revenue standard does not require the material right to be significant and incremental in relation to other discounts within the same contract.

Changing Lanes — Additional Goods or Services

Under current U.S. GAAP, entities have looked to guidance on multiple-element arrangements to distinguish between an option for additional goods or services that are identified as deliverables in an arrangement and an offer for additional goods or services. The application of that guidance to such arrangements often varies by industry. As noted, entities with software arrangements have had their own industry-specific guidance to apply. That is, in a software arrangement, an entity would account for an offer that provides a discount on future purchases of goods or services as a separate element if that discount was significant and incremental to the range of discounts reflected in the contract and to the range of discounts typically given in comparable contracts.

The FASB and IASB acknowledge in paragraph BC387 of ASU 2014-09 that the "significant and incremental" guidance in current software revenue recognition literature formed the basis for including the material right concept in the new revenue standard to distinguish between an option that gives rise to a performance obligation and an offer. However, the boards specifically decided that "even if the offered discount is not incremental to other discounts in the contract, it nonetheless could, in some cases, give rise to a material right to the customer." Accordingly, the material right notion is different from the current "significant and incremental" guidance because the boards specifically did not carry forward the language in current software revenue recognition literature when finalizing the material right concept in ASU 2014-09.

The difference between the material right concept in the new revenue standard and the "significant and incremental" guidance in current software revenue guidance is best illustrated by a simple example. Assume that an entity enters into a contract with a customer to sell (1) Product X at a price of $100 and (2) one year of related services at a price of $30. In addition, the contract contains a renewal option that allows the customer to renew the services for two more years, each year at a price of $30. The stand-alone selling price for Product X is $200, and the stand-alone selling price for each year of services for this class of customer is $60.

The customer's renewal options for years 2 and 3 would reflect a material right because a 50 percent discount ($30 contract price per year ÷ $60 stand-alone selling price per year) is incremental to the range of discounts typically given for those services to that class of customer in that market. That is, the discount is incremental to the range of discounts typically given in comparable contracts.

However, under current U.S. GAAP, if Product X was software, a 50 percent discount on the renewal periods would not be considered "significant and incremental" because it is not also incremental to the range of discounts given in the contract. That is, a 50 percent discount on the renewal periods is not incremental to the 50 percent discount given on Product X ($100 contract price ÷ $200 stand-alone selling price) or on the first year of service ($30 contract price ÷ $60 stand-alone selling price). Therefore, under current software revenue guidance, the entity would not account for the offer of a discount on the renewal periods as a separate element.

5.6.2 Determining Whether an Option for Additional Goods or Services Represents a Material Right

The example below, which is reproduced from ASC 606, illustrates a contract with an option for additional goods or services that is akin to a marketing offer and thus does not represent a material right.

ASC 606-10

Example 50 — Option That Does Not Provide the Customer With a Material Right (Additional Goods or Services)

55-340 An entity in the telecommunications industry enters into a contract with a customer to provide a handset and monthly network service for two years. The network service includes up to 1,000 call minutes and 1,500 text messages each month for a fixed monthly fee. The contract specifies the price for any additional call minutes or texts that the customer may choose to purchase in any month. The prices for those services are equal to their standalone selling prices.

55-341 The entity determines that the promises to provide the handset and network service are each separate performance obligations. This is because the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer in accordance with the criterion in paragraph 606-10-25-19(a). In addition, the handset and network service are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21).

55-342 The entity determines that the option to purchase the additional call minutes and texts does not provide a material right that the customer would not receive without entering into the contract (see paragraph 606-10-55-43). This is because the prices of the additional call minutes and texts reflect the standalone selling prices for those services. Because the option for additional call minutes and texts does not grant the customer a material right, the entity concludes it is not a performance obligation in the contract. Consequently, the entity does not allocate any of the transaction price to the option for additional call minutes or texts. The entity will recognize revenue for the additional call minutes or texts if and when the entity provides those services.

Once a material right is identified, it must be accounted for as a performance obligation. However, the identification of material rights has been the focus of many questions from stakeholders. For more information, consider the summaries, analysis, and Q&As below.

TRG Update — Need to Evaluate Quantitative and Qualitative Factors in Assessing Customer Options for Material Rights

TRG members generally agreed that in determining whether an option for future goods or services is a material right, an entity should (1) consider factors outside the current transaction (e.g., the current class of customer[10]) and (2) assess both quantitative and qualitative factors. Further, TRG members noted that an entity should also evaluate incentives and programs to understand whether they are customer options designed to influence customer behavior (i.e., an entity should consider incentives and programs from the customer's perspective) because this could be an indicator that an option is a material right.

For example, regarding certain offers, such as buy three and get one free, TRG members noted that the quantities involved are less important than the fact that an entity would be "giving away" future sales in such cases. While not determinative, such an indicator may lead an entity to conclude that a customer option is a material right.

[10] ASC 606-10-25-2 and ASC 606-10-55-42 (paragraphs 10 and B40 of IFRS 15).

Q&A 5-14 How to Evaluate Whether a Contract Option Provides a Material Right

Entities regularly grant options for goods or services in contracts with customers. Such contracts may include, but are not limited to:

- Loyalty programs in which customers accumulate points that may be used to acquire future goods or services.
- Discount vouchers.
- Renewal options.
- Contracts that include a customer's payment of a nonrefundable up-front fee and renewal options.

In some cases, such options are marketing or promotional efforts to gain future contracts with customers. However, in other cases, such options are purchased (often implicitly) in conjunction with a present customer contract. In applying step 2 of the revenue recognition guidance in ASC 606, an entity must identify performance obligations in the contract, and ASC 606-10-25-18(j) requires an entity to recognize an option as a distinct performance obligation when the option provides a customer with a material right as defined in ASC 606-10-55-41 through 55-45. Accordingly, when an option is identified as providing a customer with a material right, the option is identified as a performance obligation. A portion of the transaction price is then allocated to the option and recognized when (or as) (1) the future goods or services related to the option are provided or (2) the option expires.

Question

Is the assessment of whether an option provides a customer with a material right only a quantitative assessment?

Answer

No. When determining whether a contract option provides a material right, entities should consider not only the quantitative significance of the option (i.e., the quantitative value of the benefit) but also previous and future transactions with the customer as well as qualitative factors. Specifically, qualitative features such as whether the rights accumulate (e.g., loyalty points) are likely to provide a qualitative benefit that may give rise to a material right.

Paragraph BC87 of ASU 2014-09 indicates that an entity should consider its customer's valid expectations when identifying promised goods or services. A customer's perspective on what constitutes a material right might consider qualitative factors (e.g., whether the right accumulates). Therefore, a numeric threshold alone might not determine whether a material right is provided by a customer option in a contract.

Refer to Examples 49, 50, 51, and 52 in ASC 606-10-55-336 through 55-356 for examples of how an entity would determine whether an option provides a customer with a material right.

The TRG discussed this issue in October 2014; a summary of the TRG's discussion is available in TRG Agenda Paper 11. For additional information and Deloitte's summary, see Appendixes D and E.

See also Section 6.3.3 for discussion of how an entity should evaluate a material right for the existence of a significant financing component when determining the transaction price in step 3.

5.6.2.1 Loyalty Programs and Accumulation Features

ASC 606-10

Example 52 — Customer Loyalty Program

55-353 An entity has a customer loyalty program that rewards a customer with 1 customer loyalty point for every $10 of purchases. Each point is redeemable for a $1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for $100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed, and the standalone selling price of the purchased products is $100,000. The entity expects 9,500 points to be redeemed. The entity estimates a standalone selling price of $0.95 per point (totalling $9,500) on the basis of the likelihood of redemption in accordance with paragraph 606-10-55-44.

55-354 The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation. The entity allocates the transaction price ($100,000) to the product and the points on a relative standalone selling price basis as follows:

Product	$91,324 [$100,000 × ($100,000 standalone selling price ÷ $109,500)]
Points	$8,676 [$100,000 × ($9,500 standalone selling price ÷ $109,500)]

55-355 At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognizes revenue for the loyalty points of $4,110 [(4,500 points ÷ 9,500 points) × $8,676] and recognizes a contract liability of $4,566 ($8,676 – $ 4,110) for the unredeemed points at the end of the first reporting period.

55-356 At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognizes revenue for the loyalty points of $3,493 {[(8,500 total points redeemed ÷ 9,700 total points expected to be redeemed) × $8,676 initial allocation] – $4,110 recognized in the first reporting period}. The contract liability balance is $1,073 ($8,676 initial allocation – $7,603 of cumulative revenue recognized).

TRG Update — Accumulation Features

TRG members discussed loyalty programs that have an accumulation feature. Some TRG members noted the belief that through the presence of an accumulation feature in a loyalty program, the entity gives its customers a material right. Others, however, indicated that the accumulation feature is not a determinative factor that would automatically lead an entity to conclude that the entity grants its customers a material right. Rather, these TRG members noted that if an accumulation feature is present, an entity would be required to evaluate the program.

Thinking It Through — Accumulation Feature as a Strong Indicator of a Material Right

We believe that the existence of an accumulation feature in a loyalty program is a strong indicator of a material right, to which an entity would need to allocate a portion of the current contract's transaction price. We expect it to be a rare conclusion that loyalty programs with accumulation features are not material rights.

Q&A 5-15 Customer Loyalty Programs That Have an Accumulation Feature

Loyalty programs allow customers to accumulate points upon each purchase of goods or services; the points accumulated may then be redeemed to obtain future goods or services from the same vendor. That is, the customer is granted an option to purchase additional goods or services by redeeming the points. Accordingly, ASC 606-10-25-18(j) requires the option to be recognized as a distinct performance obligation when the option provides the customer with a material right as defined in ASC 606-10-55-41 through 55-45.

Question

In circumstances in which a customer's loyalty points accumulate with each transaction, must the entity consider points awarded for past and future transactions in addition to the current transaction when evaluating whether the customer has a material right?

Answer

Yes. The entity should evaluate the current, past, and future transactions made by the customer in evaluating whether the loyalty program provides the customer with a material right. In addition, the entity should consider both qualitative and quantitative factors and, in particular, should consider whether the material right accumulates over time (after multiple transactions). That is, the entity should consider factors related to both the current transaction and the loyalty program in its entirety when analyzing whether an option provides a material right (and should therefore be accounted for as a distinct performance obligation in accordance with ASC 606-10-25-18(j) and ASC 606-10-55-41 through 55-45).

For example, in any given transaction, the number of loyalty points awarded may not be quantitatively material; however, the structure of the loyalty program could be designed to influence customer behavior and therefore be a qualitative indicator that the option provides a material right.

The TRG discussed this issue in October 2014; a summary of the TRG's discussion is available in TRG Agenda Paper 11. For additional information and Deloitte's summary, see Appendixes D and E.

TRG Update — Considering the Class of Customer in the Evaluation of Whether a Customer Option Gives Rise to a Material Right

As noted in the TRG Update in Section 5.6.2, the TRG has discussed the factors an entity should consider when determining whether a material right exists and has generally concluded that the entity should take into account past, current, and future transactions as well as both qualitative and quantitative factors (including whether the right accumulates).

ASC 606-10-55-42 states that an "option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market)."

Stakeholder views have differed regarding how the class of customer should be considered in an entity's evaluation of whether a customer option gives rise to a material right. TRG Agenda Paper 54 provides the following examples of the FASB staff's views on this topic:

Example	Facts	FASB Staff Analysis and Views
Volume discounts	• Company A manufactures component parts that are interchangeable, are not customized, and have various uses to multiple customers. • Company A enters into long-term master service agreements with many of its customers to provide parts. Under the agreements, the future prices of the parts depend on past volume. • For example, A offers B a decrease in price from $1.00 per part in year 1 to $0.90 per part in year 2 if B purchases more than 100,000 parts in year 1. • Early in year 1, B enters into a contract with A to purchase 8,000 parts. Customer B is required to pay $1.00 for each of those 8,000 parts. • Customer C (an existing customer) places a single order for 105,000 units at a price per part of $0.90.	Company A will need to consider all relevant facts and circumstances (including the price charged to other high-volume customers) to determine whether the price offered in year 2 represents the stand-alone selling price for the part. Said differently, A would need to determine whether the discount (1) is incremental to the discount that would be offered to other similar customers (such as that offered to C) and (2) would be offered to a similar customer independently of any prior contract the customer had with A. Company A would not consider pricing offered to other customers that is contingent on prior-year volume purchases. Pricing offered to B that is comparable to pricing offered to other similar customers (and is offered independently of prior contracts with A) may be an indication that there is no incremental discount and therefore no material right. However, pricing that is not comparable may be an indication that a material right has been given to B because B has prepaid for parts in year 2.

(Table continued)

Example	Facts	FASB Staff Analysis and Views
Tier status	• An airline offers a "tier status" program with Bronze, Silver, and Platinum categories that are based on historical travel volume. • Benefits are offered to each tier and increase as customers reach the next tier. • Benefits may include the ability to check bags, access the airline's airport lounge, or upgrade to business-class seating. Customers without tier status would be charged fees incremental to the ticket purchase for such benefits. • Status tiers must be achieved by the end of the year and reset each year. Customers who have a larger volume of ticket purchases earn a higher status for the remainder of the current year and all of the next year. • The airline may also offer to match the level of status achieved by customers of a competitor's airline or who are identified as high-volume customers by other means (e.g., status at a hotel chain), even if they have not previously traveled with the airline.	The airline needs to evaluate whether the ticket purchase (the contract) includes a material right by determining whether the customer's option to receive discounted goods (e.g., a free checked bag) is independent of the current contract with the customer. In other words, the airline would need to consider whether the benefits (e.g., discounts) given under a tier status program are incremental to discounts given to a similar class of customer who did not enter into a prior contract with the airline. In performing the evaluation, the company could: • Compare the price it charges a certain tier of customer for the flight and the other status benefits associated with the price charged to a similar customer who does not have a prior contract. • Consider whether it would continue to offer customers status benefits for the subsequent year even if they failed to travel enough in the current year to maintain their tier status. • Assess whether, and how frequently, it would offer status benefits to a customer who demonstrates that he or she is a frequent traveler through other means (e.g., other airlines or hotels). The airline would not consider the price charged to other customers who received status benefits through prior contracts with the airline since doing so would not help it determine whether such discounted pricing is offered independently of the current contract.

The FASB staff noted that an entity will be required to use significant judgment to determine whether a material right is provided to the entity's customers. Further, the staff noted that it "is not in a position to reach broad conclusions about these types of fact patterns because there are many variations of contracts and variations in facts and circumstances that can impact the conclusion in each fact pattern."[11] However, the staff emphasized the following:

- The relative importance placed on the considerations discussed in the examples (or other considerations) will vary on the basis of an entity's facts and circumstances.
- The objective of the guidance in ASC 606-10-55-42 and 55-43 is to determine whether a customer option to receive discounted goods is independent of an existing contract with a customer.

For additional information, see TRG Agenda Paper 54.

TRG members debated the application of concepts in the framework the staff used to analyze the examples in TRG Agenda Paper 54 but did not reach general agreement on (1) how or when to consider past transactions in determining the class of customer and (2) how the class of customer should be evaluated in the determination of the stand-alone selling price of an optional good or service.

A few TRG members maintained that discounts or status achieved through past transactions is akin to accumulating features in loyalty programs (and that such features therefore represent material rights). However, others indicated that these programs represent marketing inducements (i.e., discounts) for future transactions that should be evaluated in relation to those offered to other similar customers or potential customers (e.g., other high-volume customers or potential high-volume customers). The TRG members who viewed the programs as marketing inducements believed that considering a customer's past transactions, among other factors, is appropriate in the evaluation of whether a good or service being offered to the customer reflects the stand-alone selling price for that class of customer in accordance with ASC 606-10-55-42 (particularly for entities that have limited alternative sources of information available upon which to establish a customer's class). Further, these TRG members focused on the facts that (1) similar discounts on future transactions (like those provided in the form of benefits and other offers in status programs for no additional fees) may be given to other customers who did not make or have the same level of prior purchases with the entity and (2) such discounts may be provided at the stand-alone selling price for that class of customer (i.e., the good or service is not priced at a discount that is incremental to the range of discounts typically offered to that class of customer and therefore do not represent a material right).

Because general agreement was not reached, certain Board members recommended that the FASB staff perform additional outreach, particularly with preparers in the travel and entertainment industries and with procurement personnel in large organizations, to understand how discounts and tier status programs are negotiated and structured. After soliciting additional input, the FASB staff will determine next steps, if any.

[11] Quoted from paragraphs 35 and 50 of TRG Agenda Paper 54.

5.6.3 Optional Purchases Versus Variable Consideration

When an entity enters into a contract to deliver a variable volume of goods or services, the entity should first determine whether the nature of its promise is to provide an option to purchase additional goods or services. However, in some contracts with customers, it may be difficult to differentiate between an option to purchase additional goods or services and variable consideration in the transaction price that is driven by variable volumes. When determining the nature of its promise in such arrangements, an entity should consider the following:

- If the customer can make a separate purchasing decision with respect to additional distinct goods or services and the entity is not presently obligated to provide those goods or services before the customer exercises its rights, the customer's ability to make that separate purchasing decision would be indicative of an option for additional goods or services.
- Conversely, if future events (which may include the customers' own actions) will not obligate the vendor to provide additional *distinct* goods or services, any additional consideration triggered by those events would instead be variable consideration.

Variable consideration driven by variable volumes is further discussed in the context of step 3 in Section 6.2.5.4.

5.6.4 Likelihood That an Option for Additional Goods or Services Will Be Exercised

Stakeholders have raised various issues related to whether an entity should assess optional purchases provided to customers to determine whether the customer is economically compelled — or highly likely — to exercise its option(s). Stakeholder questions and the related TRG discussion are further considered in Section 6.2.5.4. However, the Q&A below discusses how the FASB and IASB intended for the new revenue standard's guidance on optional purchases to be applied to customers' future purchases.

Q&A 5-16 Economic Compulsion and Optional Items

Some business models include arrangements under which a vendor will sell an up-front good or service and also provide the customer with an option to purchase other distinct goods or services in the future that are related to the up-front good or service (e.g., a specialized piece of equipment and an option to buy specialized consumables that will be needed for its operation). Such arrangements may include features that result in a degree of economic compulsion such that there is a very high level of confidence that the customer will exercise its option.

Question

In such circumstances, when it is highly probable, or even virtually certain, that the customer will exercise its option, should the additional goods or services be treated as performance obligations under the contract?

Answer

No. The treatment of customer options is explained in paragraph BC186 of ASU 2014-09, in which the FASB and IASB clarified that "the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services," making no reference to the probability that those options will be exercised.

Accordingly, irrespective of how likely it is that a customer will choose to purchase additional goods or services, the reporting entity should not treat those goods or services as performance obligations under the initial contract. Instead, the entity should evaluate the customer option (in accordance with ASC 606-10-55-41 through 55-45) to determine whether it gives rise to a material right.

The TRG discussed this issue in November 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 49. For additional information and Deloitte's summary, see Appendixes D and E.

5.6.5 Allocation of Consideration to Material Rights

ASC 606-10

55-44 Paragraph 606-10-32-29 requires an entity to allocate the transaction price to performance obligations on a relative standalone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option
b. The likelihood that the option will be exercised.

55-45 If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

An entity is required in step 4 to allocate consideration to all of the performance obligations in a contract on the basis of stand-alone selling prices. As explained in paragraph BC390 of ASU 2014-09, option pricing models can be used to estimate an option's stand-alone selling price. Allocation of the transaction price in step 4 is discussed comprehensively in Chapter 7.

5.6.6 Customer's Exercise of a Material Right

TRG Update — Accounting for a Customer's Exercise of a Material Right

The TRG discussed questions raised by stakeholders about the accounting for a customer's exercise of a material right. TRG members generally preferred the view that an entity would account for the exercise of a material right as a change in the contract's transaction price[12] (i.e., a continuation of the contract, whereby the additional consideration would be allocated to the material right). However, the TRG also believed that it would be acceptable for an entity to account for the exercise of a material right as a contract modification[13] (which may require reallocation of consideration between existing and future performance obligations). Contract modifications are discussed in Chapter 9.

The Q&A below further expands on both of these views.

[12] ASC 606-10-32-42 through 32-45 (paragraphs 87 through 90 of IFRS 15).
[13] ASC 606-10-25-10 through 25-13 (paragraphs 18 through 21 of IFRS 15).

Q&A 5-17 Accounting for the Exercise of an Option That Is a Material Right

When a contract with a customer includes a material right in the form of an option to acquire additional goods or services, the guidance in ASC 606-10-55-41 through 55-45 requires an entity to allocate part of the transaction price to that right and recognize the associated revenue when those future goods or services are transferred or when the option expires.

Question

When a contract with a customer includes such a material right, how should an entity account for the customer's subsequent exercise of the right (option)?

Answer

The guidance in ASC 606 supports two approaches, outlined below, for accounting for a customer's subsequent exercise of a material right. The method used should be applied consistently by an entity to similar types of material rights and under similar facts and circumstances.

View A

At the time a customer exercises a material right, an entity should update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise. This additional consideration should be allocated to the performance obligation underlying the material right and recognized as revenue when or as this performance obligation is satisfied. That is, the amount allocated to the material right is added to any additional amounts due as a consequence of the customer's exercise of the material right, and that total is allocated to the additional goods or services. The amounts previously allocated to the other goods and services in the contract are not revised.

View B

The exercise of a material right should be accounted for as a contract modification. The additional consideration received or the additional goods or services provided when a customer exercises a material right represent a change in the scope or the price of the contract. An entity should apply the modification guidance in ASC 606-10-25-10 through 25-13.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E. Although most TRG members thought that both Views A and B could be supported by the new revenue standard, most TRG members leaned toward View A.

Example
An entity enters into a contract with a customer to provide Product X for \$200 and Service Y for \$100. The contract also includes an option for the customer to purchase Service Z for \$300. The stand-alone selling prices of Product X, Service Y, and Service Z are \$200, \$100, and \$450, respectively. The entity concludes that the option to purchase Service Z at a discount provides the customer with a material right. The entity's estimate of the stand-alone selling price of the material right is \$100.

Example (continued)

The entity allocates the $300 transaction price ($200 for Product X plus $100 for Service Y) to each performance obligation under the contract as follows:

	Transaction Price ($)	SSP ($)	% Allocation	Allocation ($)
Product X		200	50%	150
Service Y		100	25%	75
Material right		100	25%	75
Total	300	400	100%	300

Subsequently, when the entity has delivered Product X and has delivered 60 percent of Service Y, the customer exercises its option to purchase Service Z for $300.

View A

The entity updates the transaction price to reflect the additional consideration receivable from the customer. The additional $300 payable after the exercise of the option is added to the amount of $75 that was previously allocated to the option to purchase Service Z, resulting in a total of $375. The amount of $375 is recognized as revenue over the period during which Service Z is transferred.

No change is made to the amount of revenue allocated to Product X and Service Y. The revenue not yet recognized with respect to Service Y (40% × $75 = $30) is recognized as revenue over the remaining period during which Service Y is transferred to the customer.

View B

The entity accounts for the customer's exercise of its option to purchase Service Z as a contract modification. The appropriate accounting will be different depending on whether the remaining services to be provided after the modification (i.e., Service Z and the rest of Service Y) are distinct from those transferred to the customer before the modification.

Accounting If the Remaining Services Are Distinct

If the entity determines that the remaining services to be provided after the modification are distinct from those transferred to the customer before the modification, the guidance in ASC 606-10-25-13(a) should be applied. The revenue already recognized with respect to Product X ($150) and 60 percent of Service Y ($75 × 60% = $45) is not adjusted.

After the modification, the revenue not yet recognized is determined as follows:

	$
Adjusted transaction price ($300 + $300)	600
Revenue already recognized ($150 + $45)	(195)
Revenue not yet recognized	405

Example (continued)

The revenue not yet recognized is then allocated to the remaining performance obligations as follows:

	Transaction Price ($)	SSP ($)	% Allocation	Allocation ($)
Service Y (40%)		40	8.2%	33
Service Z		450	91.8%	372
Total	405	490	100%	405

Therefore, $33 is recognized as the remaining 40 percent of Service Y is delivered, and $372 is recognized as Service Z is delivered.

Accounting If the Remaining Services Are Not Distinct

If the entity determines that the remaining goods or services are not distinct, the guidance in ASC 606-10-25-13(b) should be applied and a cumulative catch-up adjustment to revenue for performance obligations satisfied over time should be recognized on the date of the modification (no adjustment is made for fully satisfied performance obligations). The updated transaction price is allocated between the two performance obligations that are satisfied over time as if the modification had been in place at the start of the contract.

	Transaction Price ($)	SSP ($)	% Allocation	Allocation ($)
Service Y		100	18.2%	82
Service Z		450	81.8%	368
Total	450*	550	100%	450

* Calculated as $150 ($75 allocated to Service Y plus $75 allocated to the material right) plus the $300 exercise price of the material right. The $150 allocated to Product X is excluded because the performance obligation has been fully satisfied and is distinct from Service Y and Service Z.

The cumulative catch-up adjustment is recorded because the remaining 40 percent of Service Y is not distinct from the previously delivered 60 percent of Service Y (Service Y is distinct from Service Z) and is determined as follows:

	$
Revenue based on updated allocation for 60% of Service Y (60% × $82 = $49)	49
Revenue previously recognized for Service Y ($45)	(45)
Additional revenue recognized as catch-up adjustment	4

Therefore, the remaining $33 ($82 – $49) is recognized as the entity performs the remaining 40 percent of Service Y, and $368 is recognized as Service Z is delivered.

5.6.7 Vouchers, Discounts, and Coupons

Some of the more common scenarios in which an entity may provide options to purchase additional goods or services involve options in the form of vouchers, discounts, and coupons. The Codification example and Q&As below discuss how entities would apply the new revenue guidance on optional purchases in those scenarios.

ASC 606-10

Example 49 — Option That Provides the Customer With a Material Right (Discount Voucher)

55-336 An entity enters into a contract for the sale of Product A for $100. As part of the contract, the entity gives the customer a 40 percent discount voucher for any future purchases up to $100 in the next 30 days. The entity intends to offer a 10 percent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 percent discount cannot be used in addition to the 40 percent discount voucher.

55-337 Because all customers will receive a 10 percent discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10 percent (that is, the additional 30 percent discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

55-338 To estimate the standalone selling price of the discount voucher in accordance with paragraph 606-10-55-44, the entity estimates an 80 percent likelihood that a customer will redeem the voucher and that a customer will, on average, purchase $50 of additional products. Consequently, the entity's estimated standalone selling price of the discount voucher is $12 ($50 average purchase price of additional products × 30 percent incremental discount × 80 percent likelihood of exercising the option). The standalone selling prices of Product A and the discount voucher and the resulting allocation of the $100 transaction price are as follows:

Performance Obligation	Standalone Selling Price
Product A	$ 100
Discount voucher	12
Total	$ 112

Performance Obligation	Allocated Transaction Price	
Product A	$ 89	($100 ÷ $112 × $100)
Discount voucher	11	($12 ÷ $112 × $100)
Total	$ 100	

55-339 The entity allocates $89 to Product A and recognizes revenue for Product A when control transfers. The entity allocates $11 to the discount voucher and recognizes revenue for the voucher when the customer redeems it for goods or services or when it expires.

Q&A 5-18 Options to Purchase Goods at a Discount — Vouchers Available With or Without the Requirement to Make an Initial Purchase

In an effort to increase sales, Supermarket B offers two separate marketing programs to its customers:

- *Program 1* — All visitors to B, irrespective of whether they make any other purchases, can pick up a voucher entitling them to a reduction of $1 from the usual $10 selling price of Product X.
- *Program 2* — Customers who purchase Product W for its normal selling price of $7 will receive a voucher entitling them to a reduction of $5 from Product X's selling price.

Only one voucher can be used for any purchase of Product X. It has been determined that the option granted to purchasers of Product W to purchase Product X for $5 instead of $9 (i.e., the purchase price when the $1 voucher is redeemed) gives those customers a material right.

Question

How should B account for the two different types of vouchers?

Answer

The $1 vouchers issued under Program 1 are not within the scope of ASC 606. Because the customer does not enter into any enforceable commitment by picking up a $1 voucher, no contract arises from the $1 vouchers.

As a result, B should simply treat the $1 vouchers as a price reduction when customers use the $1 vouchers to purchase Product X. Therefore, if a customer uses a $1 voucher to purchase Product X for $9, the revenue recognized will be $9 since this is the consideration to which B is entitled in exchange for Product X (when the $1 vouchers are taken into account).

However, the $5 voucher issued under Program 2 is within the scope of ASC 606 because customers are entitled to the $5 vouchers as part of a sales transaction (i.e., the contract to purchase Product W).

Therefore, in accounting for the $5 vouchers, B should consider the guidance in ASC 606-10-55-41 through 55-45 on customer options for additional goods or services. According to this guidance, because the option gives the customer a material right that it would not receive without entering into the contract, a separate performance obligation is established.

ASC 606-10-55-44 specifies that entities should measure this obligation, if it is not directly observable, by applying an estimate that reflects "the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option
b. The likelihood that the option will be exercised."

In assessing the stand-alone selling price of the $5 vouchers, B should consider (1) that customers not making a purchase could still have claimed a $1 voucher (i.e., the incremental value of the $5 voucher to the customer would therefore be $4) and (2) the likelihood that the $5 voucher will be redeemed.

Accordingly, the stand-alone selling price of the $5 vouchers that will be used to allocate the transaction price to the performance obligation for the discount voucher will not exceed the additional discount of $4, and it may be lower depending on the proportion of vouchers expected to be redeemed. The entity recognizes revenue related to the $5 vouchers when Product X is transferred to a customer, taking into account the guidance in ASC 606-10-55-46 through 55-49 (discussed in Q&A 6-17) on vouchers not expected to be redeemed.

Q&A 5-19 Stand-Alone Selling Price for Gift Cards That Can Be Purchased Individually or in Combination With Other Goods or Services

Entity T gives away a $10 gift card to customers if they purchase a particular brand of headphones. These gift cards are also sold on a stand-alone basis at face value. Regardless of whether they are given away or sold, these gift cards are only redeemable against future music downloads made by customers from T's Web site to the value of $10.

Entity T has consistent historical experience as follows:

- When sold on a stand-alone basis, the gift cards have a 95 percent redemption rate.
- When given away to customers who purchase headphones, the gift cards have a 40 percent redemption rate.

Entity T has determined that the gift cards given to the customers who purchase headphones provide those customers with a material right. Accordingly, they give rise to a performance obligation under the contract to sell the headphones to which part of the transaction price should be allocated (see ASC 606-10-55-41 through 55-45 for details).

Question

In allocating the transaction price for purchases of headphones that include a gift card, should T use a stand-alone selling price for the gift card that is different from the cash price charged to customers buying only a gift card?

Answer

Yes. As discussed in Q&A 7-3, different stand-alone selling prices can arise for the same item when the sales are in dissimilar circumstances or to dissimilar customers.

In the scenarios described above, the circumstances of the purchase of the gift cards can be seen to be dissimilar. In particular, customers who purchase the bundle are receiving gift cards regardless of whether they want the cards, in contrast with customers who make a conscious decision to purchase a gift card; and these different circumstances are reflected in the markedly different redemption rates.

Accordingly, the stand-alone selling price of a gift card given away with headphones is not directly observable; it cannot be assumed to be the same as the price of a gift card purchased in isolation because the sales occur in dissimilar circumstances. When a stand-alone selling price is not directly observable, it should be estimated in accordance with ASC 606-10-55-44, with that estimate reflecting both the discount that the customer will receive on exercising the option ($10 in the circumstances described above) and the likelihood that the option will be exercised.

Consequently, in the circumstances under consideration, and assuming that a customer could not receive any other discount on downloading music from T (which would also be reflected in the estimate required by ASC 606-10-55-44), the stand-alone selling price of a gift card purchased together with a set of headphones might be assessed as $4 (40 percent of $10).

5.6.8 Renewal Options

Paragraph BC391 of ASU 2014-09 explains that contracts could describe renewal options as either (1) renewal options, which are basically extensions of the current contract, or (2) early cancellations, which are the option for a customer to end a long contract earlier than planned. A customer option to renew could be considered an option for additional goods or services, which then opens the door for the entity to consider whether the option is a material right (i.e., a performance obligation).

When options for additional goods or services are considered material rights, an entity is required to estimate the options' stand-alone selling price so that consideration from the contract can be allocated to the options. Since renewal options are similar to options for additional goods or services, an entity would have to determine an estimate of the options' stand-alone selling price for each renewal period, which may be complex.

However, as explained in paragraphs BC392 through BC395 of ASU 2014-09, the FASB and IASB decided to provide a practical alternative for renewal options that allows an entity to "include the optional goods or services that it expects to provide (and corresponding expected customer consideration) in the initial measurement of the transaction price." To differentiate contract renewal options from options for additional goods or services (the latter of which are not eligible for the practical alternative), the boards developed two criteria that must be met for an entity to apply the practical alternative:

- The additional goods or services in the renewal options are similar to those provided in the initial contract.
- The renewal options' terms and conditions related to goods or services are the same as those of the original contract.

Example 51 from ASC 606 and the Q&A below illustrate these concepts.

ASC 606-10

Example 51 — Option That Provides the Customer With a Material Right (Renewal Option)

55-343 An entity enters into 100 separate contracts with customers to provide 1 year of maintenance services for $1,000 per contract. The terms of the contracts specify that at the end of the year, each customer has the option to renew the maintenance contract for a second year by paying an additional $1,000. Customers who renew for a second year also are granted the option to renew for a third year for $1,000. The entity charges significantly higher prices for maintenance services to customers that do not sign up for the maintenance services initially (that is, when the products are new). That is, the entity charges $3,000 in Year 2 and $5,000 in Year 3 for annual maintenance services if a customer does not initially purchase the service or allows the service to lapse.

55-344 The entity concludes that the renewal option provides a material right to the customer that it would not receive without entering into the contract because the price for maintenance services are significantly higher if the customer elects to purchase the services only in Year 2 or 3. Part of each customer's payment of $1,000 in the first year is, in effect, a nonrefundable prepayment of the services to be provided in a subsequent year. Consequently, the entity concludes that the promise to provide the option is a performance obligation.

55-345 The renewal option is for a continuation of maintenance services, and those services are provided in accordance with the terms of the existing contract. Instead of determining the standalone selling prices for the renewal options directly, the entity allocates the transaction price by determining the consideration that it expects to receive in exchange for all the services that it expects to provide in accordance with paragraph 606-10-55-45.

55-346 The entity expects 90 customers to renew at the end of Year 1 (90 percent of contracts sold) and 81 customers to renew at the end of Year 2 (90 percent of the 90 customers that renewed at the end of Year 1 will also renew at the end of Year 2, that is 81 percent of contracts sold).

ASC 606-10 (continued)

55-347 At contract inception, the entity determines the expected consideration for each contract is $2,710 [$1,000 + (90 percent × $1,000) + (81 percent × $1,000)]. The entity also determines that recognizing revenue on the basis of costs incurred relative to the total expected costs depicts the transfer of services to the customer. Estimated costs for a three-year contract are as follows:

Year 1	$ 600
Year 2	$ 750
Year 3	$ 1,000

55-348 Accordingly, the pattern of revenue recognition expected at contract inception for each contract is as follows:

	Expected Costs Adjusted for Likelihood of Contract Renewal		Allocation of Consideration Expected	
Year 1	$ 600	($600 × 100%)	$ 780	[($600 ÷ $2,085) × $2,710]
Year 2	675	($750 × 90%)	877	[($675 ÷ $2,085) × $2,710]
Year 3	810	($1,000 × 81%)	1,053	[($810 ÷ $2,085) × $2,710]
Total	$ 2,085		$ 2,710	

55-349 Consequently, at contract inception, the entity allocates to the option to renew at the end of Year 1 $22,000 of the consideration received to date [cash of $100,000 – revenue to be recognized in Year 1 of $78,000 ($780 × 100)].

55-350 Assuming there is no change in the entity's expectations and the 90 customers renew as expected, at the end of the first year, the entity has collected cash of $190,000 [(100 × $1,000) + (90 × $1,000)], has recognized revenue of $78,000 ($780 × 100), and has recognized a contract liability of $112,000.

55-351 Consequently, upon renewal at the end of the first year, the entity allocates $24,300 to the option to renew at the end of Year 2 [cumulative cash of $190,000 – cumulative revenue recognized in Year 1 and to be recognized in Year 2 of $165,700 ($78,000 + $877 × 100)].

55-352 If the actual number of contract renewals was different than what the entity expected, the entity would update the transaction price and the revenue recognized accordingly.

Q&A 5-20 Evaluation of Material Rights — Options for Renewal of Media Contracts

Television studios often enter into contracts with broadcasters for the broadcast of the first season of a new television show, with an exclusive pickup option for the broadcaster to license any subsequent seasons of the show for a fixed fee per season. After contract inception, the value of this option may change depending on the success of the first season.

Question

Does an option within an initial license for a broadcaster to obtain additional content for a fixed fee represent a material right (i.e., a separate performance obligation) as contemplated in ASC 606-10-55-42?

Answer

It depends. Under ASC 606-10-55-42, a material right exists if the fixed fee for the option reflects a discount that would not have been offered if the broadcaster had not purchased the license for the first season. Conversely, a material right does not exist if the fixed fee for the option represents the option's stand-alone selling price at contract inception.

In the circumstances described, it may be difficult to estimate the stand-alone selling price of the option (because options of this type are not typically sold separately and their value is affected by the likelihood of success of the initial season, which may be unknown at contract inception). Consequently, entities will need to use judgment in making this evaluation. Although the value of such an option may subsequently increase if a show is successful, whether there is a material right should be assessed only by reference to the value of that option at contract inception.

5.7 Nonrefundable Up-Front Fees

ASC 606-10

55-50 In some contracts, an entity charges a customer a nonrefundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, activation fees in telecommunication contracts, setup fees in some services contracts, and initial fees in some supply contracts.

55-51 To identify performance obligations in such contracts, an entity should assess whether the fee relates to the transfer of a promised good or service. In many cases, even though a nonrefundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer (see paragraph 606-10-25-17). Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognized as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right as described in paragraph 606-10-55-42.

55-52 If the nonrefundable upfront fee relates to a good or service, the entity should evaluate whether to account for the good or service as a separate performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

55-53 An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity should assess whether costs incurred in setting up a contract have resulted in an asset that should be recognized in accordance with paragraph 340-40-25-5.

Nonrefundable up-front fees are payments made by customers at the start of a contract for various reasons. The new revenue standard cites health club membership fees, activation fees in telecommunication contracts, and set-up fees as examples of nonrefundable up-front fees. Entities need to assess nonrefundable up-front fees to determine whether the fees (1) are for goods or services provided at contract inception or (2) provide the customer with an option for additional goods or services that gives rise to a material right (a performance obligation).

Example 53 from ASC 606 illustrates the application of the new revenue guidance on nonrefundable up-front fees.

ASC 606-10

Example 53 — Nonrefundable Upfront Fees

55-358 An entity enters into a contract with a customer for one year of transaction processing services. The entity's contracts have standard terms that are the same for all customers. The contract requires the customer to pay an upfront fee to set up the customer on the entity's systems and processes. The fee is a nominal amount and is nonrefundable. The customer can renew the contract each year without paying an additional fee.

55-359 The entity's setup activities do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation.

55-360 The entity concludes that the renewal option does not provide a material right to the customer that it would not receive without entering into that contract (see paragraph 606-10-55-42). The upfront fee is, in effect, an advance payment for the future transaction processing services. Consequently, the entity determines the transaction price, which includes the nonrefundable upfront fee, and recognizes revenue for the transaction processing services as those services are provided in accordance with paragraph 606-10-55-51.

Thinking It Through — No Real Change From Current Guidance

We do not think that the identification of performance obligations related to nonrefundable up-front fees under the new revenue standard is a significant change from the identification of deliverables related to nonrefundable up-front fees under current revenue guidance. Currently, SAB Topic 13 includes specific rules related to the recognition of revenue from nonrefundable up-front fees. However, under both current revenue guidance and the new revenue standard, an entity would, in effect, first assess whether a nonrefundable up-front fee is related to the transfer of a promised good or service that is distinct.

Q&A 5-21 Accounting for a Nonrefundable Up-Front Fee

Entity X agrees to provide a customer with services on a monthly basis at a price of $400 per month, payable at the start of each month. At the outset, X also charges the customer a one-time, nonrefundable up-front fee of $50, for which no separate goods or services are transferred. The customer can cancel the contract at any time without penalty, but it will not be entitled to any refund of amounts already paid. Entity X's average customer life is two years.

Question

Over what period should the entity recognize the nonrefundable up-front fee?

Answer

The period over which the up-front fee should be recognized depends on whether the up-front fee provides the customer with a material right with respect to renewing X's services. In determining whether the up-front fee provides the customer with such a material right, X should consider both quantitative and qualitative factors (e.g., the renewal price compared with the price a new customer would pay or the price paid for services already transferred, inclusive of the nonrefundable up-front fee).

If X concludes that the up-front fee does provide a material right, that fee should be recognized over the service period during which the customer is expected to benefit from not having to pay a further up-front fee upon renewal of service.

If X concludes that the up-front fee does not provide the customer with a material right, the entire transaction price of $450 (which comprises the minimum one-month service fee and the up-front fee) is viewed as advance payment for the promised services (i.e., the first month only) and should be recognized over the first month during which the services are provided.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

Chapter 6 — Step 3: Determine the Transaction Price

6.1 Overview

The FASB and IASB decided, as described further in paragraph BC181 of ASU 2014-09, that revenue should be measured on the basis of an allocated transaction price. This measurement principle (allocated transaction price) is intentionally different from fair value, another model evaluated by the boards in the early stages of the revenue project. A fair value measurement objective would have required a significant change to much of revenue accounting. Despite the merits of such an approach, it was ultimately not pursued by the boards in any of the public exposure documents. Rather, the underlying measurement principle (i.e., an allocated transaction price approach) outlined in the new revenue standard is not significantly different from many aspects of current practice.

As noted in paragraph BC183 of ASU 2014-09, the allocated transaction price approach in the new revenue guidance generally requires an entity to proceed in three main phases. The first of these phases, determining the transaction price, is the pillar of that measurement approach. The transaction price determined in the first phase will be allocated in step 4 to the performance obligations identified in step 2 (phase 2) for recognition in step 5 (phase 3). ASC 606-10-32-2 provides the following guidance on determining the transaction price:

ASC 606-10

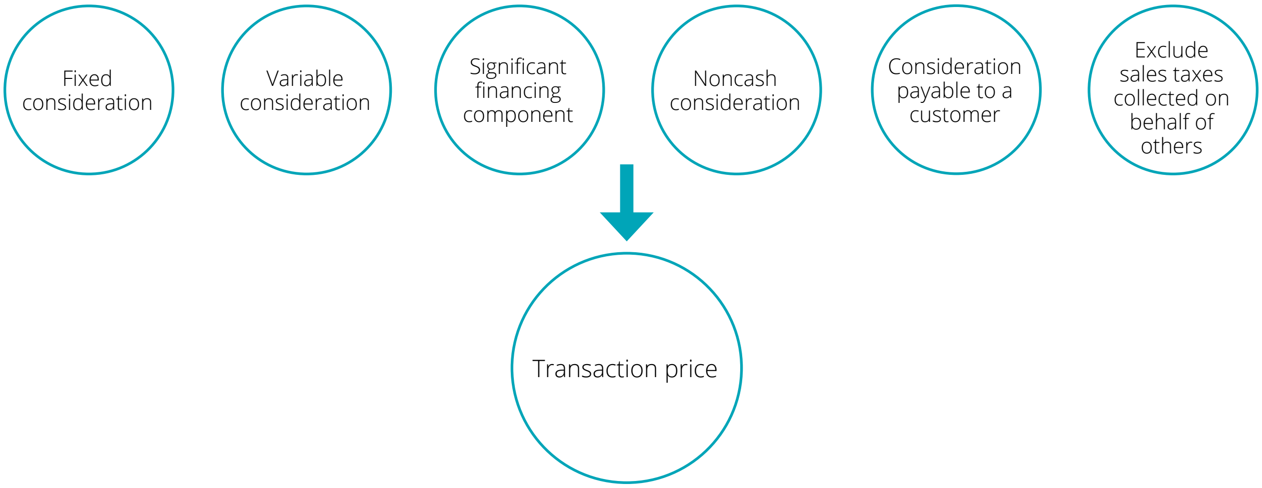
32-2 An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

Thinking It Through — Determining the Transaction Price at the Contract Level

Inherent in ASC 606-10-32-2 is that an entity's determination of the transaction price is a measurement at the contract level, as opposed to a lower level (an individual performance obligation) or a higher level (an overall customer relationship). The new revenue standard's allocation objective is to allocate the transaction price to each performance obligation. Accordingly, the transaction price must be determined in step 3 at the contract level before it can be allocated to the distinct units of account at a lower level (i.e., the performance obligations) in step 4.

The new revenue standard establishes the "transaction price" as an amount to which the entity expects to be entitled to under the contract. That is, it is an expected amount, and so inherently, estimates are required. The boards intentionally used the wording "be entitled" rather than "receive" or "collect" to distinguish collectibility risk from other uncertainties that may occur under the contract (see Chapter 4 for further discussion of where collectibility risk falls in the new revenue model). The uncertainties that *are* measured as part of the transaction price are further discussed in the sections below.

6.1.1 Components of the Transaction Price



ASC 606-10

32-3 The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

a. Variable consideration (see paragraphs 606-10-32-5 through 32-10 and 606-10-32-14)

b. Constraining estimates of variable consideration (see paragraphs 606-10-32-11 through 32-13)

c. The existence of a significant financing component in the contract (see paragraphs 606-10-32-15 through 32-20)

d. Noncash consideration (see paragraphs 606-10-32-21 through 32-24)

e. Consideration payable to a customer (see paragraphs 606-10-32-25 through 32-27).

32-4 For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

Paragraph BC185 of ASU 2014-09 states that the FASB and IASB defined "transaction price" in such a manner as to require an entity, at the end of each reporting period, "to predict the total amount of consideration to which the entity will be entitled from the contract" with the customer. In meeting this objective, an entity should evaluate those elements that affect the nature, timing, and uncertainty of cash flows related to its revenues and reflect such elements in its measurement of revenue.

In paragraph BC188 of ASU 2014-09, the boards acknowledge that determining the transaction price in a contract that contains only fixed or known cash flows will be simple. However, because of the nature of certain pricing features and cash flow structures, determining the amount to which an entity will be entitled will be inherently complex in many contracts. In light of this, the boards also acknowledge that determining the transaction price in step 3 will be more difficult when contracts with customers contain:

- Consideration that is variable until the resolution of future uncertainties (i.e., variable consideration).
- Financing components that are significant to the contract's overall cash flow stream and pricing (i.e., significant financing components).

- Consideration in a form other than cash (i.e., noncash consideration).
- Consideration that is payable by the entity to its customer (i.e., consideration payable to a customer).

Further, paragraph BC187 of ASU 2014-09 notes that it may be more difficult to determine the transaction price when amounts to which an entity is entitled are sourced from parties other than a customer (e.g., a manufacturer's payments to a retailer as a result of a customer's use of a manufacturer's coupon at the retailer's store). The boards clarified that such amounts are included in an entity's determination of the transaction price.

However, because the boards established the transaction price as an amount to which the entity expects to be entitled (and not an amount that the entity expects to *collect*), the transaction price by design generally excludes one measurement component that is common in other aspects of accounting — namely, credit risk. Consider the Q&A below.

Q&A 6-1 Effect of a Customer's Credit Risk on the Determination of the Transaction Price

Question

When should an entity take a customer's credit risk into account when measuring the transaction price?

Answer

An entity should only take a customer's credit risk into account when determining the discount rate used to adjust the promised consideration for a significant financing component, if any.

ASC 606-10-32-2 specifies that the transaction price is the amount to which an entity expects to be entitled rather than the amount it expects to collect. The determination of the amount to which an entity expects to be entitled is not affected by the risk of whether it expects the customer to default (i.e., the customer's credit risk). Paragraphs BC260 and BC261 of ASU 2014-09 explain that this approach was adopted to enable users of the financial statements to analyze "gross" revenue (i.e., the amount to which the entity is entitled) separately from the effect of receivables management (or bad debts).

However, when the timing of payments due under the contract provides the customer with a significant benefit of financing, the transaction price is adjusted to reflect the time value of money. Paragraph BC239 of ASU 2014-09 indicates that in such circumstances, an entity will take a customer's credit risk into account in determining the appropriate discount rate to apply. As illustrated in Q&A 6-22, this rate will affect the amount of revenue recognized for the transfer of goods or services under the contract.

Further, a customer's credit risk is a factor in the determination of whether a contract exists, because one of the criteria for identification of a contract in ASC 606-10-25-1 is that collection of consideration to which the entity is entitled is probable (specifically, ASC 606-10-25-1(e)). See Chapter 4 for further discussion of how a customer's credit risk affects an entity's identification of its contract with the customer in step 1.

Current revenue guidance includes some, but not comprehensive, guidance on variable consideration and the other topics noted above. In addition, ASC 605 is silent on whether the time value of money should be taken into account when a customer pays in advance (i.e., it is silent on financing components). ASC 606, however, contains significantly more guidance on applying the principles in the revenue model in these situations, as well as examples to illustrate the intent of that guidance. Consequently, most of the discussion in Chapter 6 focuses on these situations, in which determining the transaction price in a contract with a customer may be more difficult.

6.1.2 Fixed Consideration

Cash flows in a contract with a customer that are known as of contract inception and do not vary during the contract are the simplest inputs in the determination of the transaction price. Sometimes, both price and quantity in an arrangement are fixed in such a way that the total transaction price calculated as price times quantity (P × Q) is also fixed.

For example, assume that an entity enters into a contract with a customer to sell 10 widgets every month for 24 months at a price of $100 per widget. Both P ($100 per widget) and Q (10 widgets per month for 24 months) are known and do not vary during the term of the contract. Accordingly, the total transaction price is quantitatively fixed and known and can be calculated as $100 × (10 × 24) = $24,000.

Changing Lanes — Nonrefundable Up-Front Fees

Current revenue guidance in SAB Topic 13 includes specific rules related to the recognition of revenue from nonrefundable up-front fees. However, under the new revenue standard, nonrefundable up-front fees are included in the transaction price in step 3 as if they were any other type of fixed consideration. That is, if consideration is fixed, it is included in the transaction price regardless of when it is paid (ignoring any potential significant financing component, which is discussed in Section 6.3). For example, nonrefundable up-front fees received in exchange for the future delivery of a good or service may reflect fixed consideration in a contract with a customer. The consideration may be allocated in step 4 across performance obligations, but at the contract level, the fee received by the entity up front is fixed consideration.

However, as discussed in Section 6.2 below, the boards established variable consideration as a very broad concept in the new revenue standard. More specifically, the concept includes any variability in the ultimate amount of consideration to which the entity will be entitled. As a result, there are many arrangements that will include variable consideration. While there may be guaranteed minimums in arrangements, or up-front nonrefundable fixed amounts received in advance of work that may contribute to a fixed portion of consideration in an arrangement, those circumstances are often coupled with forms of variable consideration. Unless the amount to which an entity will be entitled will not vary in the future for any reason, the total consideration in the arrangement is not fixed.

For example, an arrangement would include variable consideration if the contract (implicitly or explicitly) allows for the customer to return the product (e.g., a right of return), past practice indicates that the seller will accept a lower amount of consideration as a price concession or discount, or there are any other adjustments to the ultimate amount to which an entity will be entitled in exchange for its goods or services. Further, an arrangement may include a fixed amount as a bonus payment if certain conditions are met. Although that amount may be quantitatively fixed, it nonetheless is not considered fixed consideration because the ultimate resolution of whether the entity will be entitled to that amount is subject to the occurrence or nonoccurrence of the event outlined in the contract. Accordingly, while known or quantitatively fixed amounts of consideration may sometimes be easier to identify and may even require less challenging estimation techniques, they will not be considered fixed consideration under the new revenue standard if they can vary in the future for any reason.

Therefore, many arrangements will include some or many different forms of variable consideration.

6.2 Variable Consideration

ASC 606-10

32-6 An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

32-7 The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

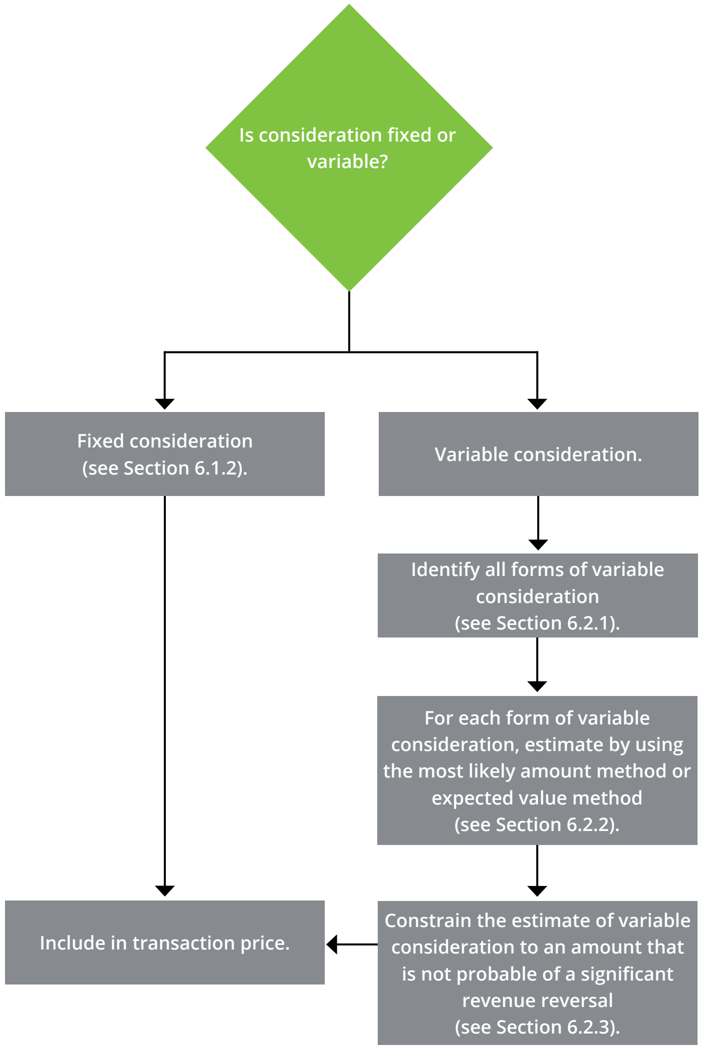
a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

Changing Lanes — Accounting Models for Variable Consideration

Current revenue recognition guidance does not provide a single model for the evaluation of variable consideration. Industry- and transaction-specific guidance includes requirements for only some forms of variable or contingent consideration. For example, SAB Topic 13 requires the selling price to be fixed or determinable before revenue is recognized. Further, ASC 605-15-25 (formerly FAS 48) provides guidance on determining the amount of revenue to recognize on sales of products when a right of return exists, and ASC 605-35 (formerly SOP 81-1) provides measurement guidance on construction- and production-type contracts. As a result, when arrangements were directly within the scope of that guidance, it was clear how to account for the variability. However, most arrangements were not always clearly within the scope of that specific guidance. For example, a contract could possess characteristics such as product returns (which would allow for estimation), to which the general model under SAB Topic 13 (which generally excludes contingent amounts) could also be applicable.

ASC 606, on the other hand, creates a single framework under which an entity assesses variable consideration in a contract with a customer to determine the amount to include in its transaction price. The decision tree below illustrates the application of that framework.



6.2.1 Identifying Variable Consideration

As the FASB and IASB acknowledge in paragraph BC190 of ASU 2014-09, consideration in a contract with a customer may vary as a result of many different factors, and variability may arise in many different circumstances. Variable consideration is easiest to identify in a contract when price (P) or quantity (Q), or both, are not fixed and known at the contract's inception.

For example, an entity may enter into a contract with a customer to sell 1,000 barrels of crude oil every month for 12 months at the prevailing market index price for the contract's delivery location. The entity determines that (1) the contract meets the criteria in ASC 606-10-25-1 to be accounted for as a contract with a customer and (2) each barrel of oil delivered is a distinct performance obligation in accordance with ASC 606-10-25-14(a). In this arrangement, Q is fixed, but P varies on the basis of changes in the market price of oil. As a result, the total transaction price calculation of P × Q is variable.

The identification of variable consideration may become more complicated when only *part* of P or Q, or both, is not fixed and known at the contract's inception. Assume the facts of the preceding example, except that the price of each barrel of crude oil is the prevailing market index price plus $5. Now, part of the transaction price is fixed because regardless of the market price of oil, the entity will receive consideration of at least P × Q = $5 × (1,000 × 12) = $60,000.

The boards acknowledge in paragraphs BC190 through BC194 of ASU 2014-09 that consideration in a contract may vary as a result of unresolved contingencies (i.e., variability in transaction price inputs other than P or Q). In these instances, the occurrence or nonoccurrence of a future event would trigger a cash flow stream in the contract. Such contingency-based variability may be explicit in a contract (e.g., a contract providing for a sale with a right of return, as noted in paragraph BC191).

Example 20 in ASC 606 illustrates a performance penalty (bonus) as a form of explicit contingency-based variable consideration.

ASC 606-10

Example 20 — Penalty Gives Rise to Variable Consideration

55-194 An entity enters into a contract with a customer to build an asset for $1 million. In addition, the terms of the contract include a penalty of $100,000 if the construction is not completed within 3 months of a date specified in the contract.

55-195 The entity concludes that the consideration promised in the contract includes a fixed amount of $900,000 and a variable amount of $100,000 (arising from the penalty).

55-196 The entity estimates the variable consideration in accordance with paragraphs 606-10-32-5 through 32-9 and considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

The boards also note in paragraph BC192 of ASU 2014-09 that they decided to include in the determination of the transaction price consideration that is implicitly variable in the arrangement. The consideration to which an entity is ultimately entitled may be less than the price stated in the contract because the customer may be offered a price concession. This creates variability in the amount to which an entity expects to be entitled and is thus a form of variable consideration even though there is no explicitly stated price concession in the contractual terms. Accordingly, an entity should consider all facts and circumstances in a contract with a customer to determine whether it would accept an amount that is lower than the consideration stated in the contract. If so, the total transaction price is variable because it is contingent on the occurrence or nonoccurrence of an event (i.e., the entity's grant of an implicit price concession to the customer).

Entities will need to use significant judgment in determining whether they have provided an implicit price concession (i.e., whether they have the expectation of accepting less than the contractual amount of consideration in exchange for goods or services) or have accepted a customer's credit risk (i.e., whether they have accepted the risk of collecting less consideration than what they legitimately expected to collect from the customer). Credit risk, as noted in Q&A 6-1, is not measured as part of the transaction price but is addressed in step 1 of the revenue model as part of the gating analysis of whether revenue from a contract with a customer should be recognized in accordance with ASC 606. Further, Q&A 4-4 in Chapter 4 discusses indicators of when the variability between the contractually stated price and the amount the entity expects to collect is due to a price concession.

In addition to the forms of variability already discussed, the following are common features in contracts with customers that also may be more difficult to identify as variable consideration but nevertheless drive variability in contract consideration:

- Royalty arrangements (further discussed in Section 6.2.5.1).
- Product returns and other customer credits (further discussed in Sections 6.2.5.2 and 6.2.5.3).
- Variable quantities and volumetric optionality (further discussed in Section 6.2.5.4).
- Rebates (volume-based rebates are further discussed in Q&A 6-12).
- Discounts (cash discounts are further discussed in Q&A 6-7; and volume discounts are discussed in Example 24 from ASC 606, which is included in Section 6.2.5.4).
- Performance-based bonuses or penalties (further discussed in the context of bonuses in Q&A 6-2; and also further discussed in the context of both bonuses and penalties and in Example 21 of ASC 606, which is included in Section 6.2.2).

6.2.2 Estimating Variable Consideration

Regardless of the form of variability or its complexity, once variable consideration is identified, an entity must estimate the amount of variable consideration to determine the transaction price in a contract with a customer.

ASC 606-10

32-5 If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

ASC 606-10

32-8 An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value — The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
b. The most likely amount — The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

32-9 An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

Paragraph BC199 of ASU 2014-09 notes that in deliberating the new revenue guidance, the FASB and IASB "observed that users of financial statements are most interested in knowing the total amount of consideration that ultimately will be realized from the contract." The boards decided that the most decision-useful information about the transaction price in a contract with a customer is an estimate that will better predict the amount of consideration to which the entity will be entitled. The concept of transaction price (i.e., the amount to which the entity expects to be entitled) differs from that of fair value. The transaction price is a contract-specific measurement that is determined on the basis of the entity's estimation process (which inherently incorporates historical practice and forward expectations), whereas fair value is a market-based measurement.

Initially, the boards decided that a probability-weighted model of measuring the transaction price at its expected value best allowed entities to predict the amount of consideration to which they will ultimately be entitled. In the 2010 exposure draft, the boards proposed requiring a single estimation technique of expected value. However, in light of feedback on the practical challenges of such an approach, the boards were sympathetic to stakeholders' concerns about fact patterns with, for example, an "all or nothing" performance bonus (in which the entity would either receive the entire performance bonus or nothing). Specifically, as noted in paragraph BC200 of ASU 2014-09, the boards acknowledged that in a contract with variable consideration that could result in only one of two outcomes upon the occurrence of a binary event (such as in the "all or nothing" performance bonus fact patterns), an expected value calculated through probability weighting would not be one of those two possible outcomes and thus would not be a decision-useful estimate. Consequently, the boards decided that both an expected value method and a most likely amount method are acceptable for an entity to consider when selecting the most appropriate method of estimating variable consideration within the parameters of the objective in ASC 606-10-32-8 (see Q&A 6-2 for further discussion of selecting the most appropriate method).

Thinking It Through — Using the Most Likely Amount Method or the Expected Value Method to Estimate Variable Consideration

As stated in the first sentence of ASC 606-10-32-9, a single method of estimating variable consideration should be used *throughout* the term of the contract with the customer. That is, the method of estimating variable consideration should not be reassessed or changed once it is selected as the most appropriate.

In paragraph BC197 of ASU 2014-09, the boards briefly discuss "management's best estimate" as a method of estimating variable consideration and acknowledge stakeholders who noted in deliberations that such a method "would provide management with the flexibility to estimate on the basis of its experience and available information without the documentation that would be required when a measurement model is specified." However, as noted in paragraph BC201 of ASU 2014-09, the boards do not anticipate that either the most likely amount method or the expected value method of estimating variable consideration will be too costly or complex for entities to apply to contracts with customers. Specifically, the boards allow that an entity would *not* be expected to develop complex modeling techniques to identify all possible outcomes of variable consideration when determining the most likely outcome or a probability distribution of outcomes. Thus, the benefits of applying the most likely amount method or the expected value method to estimate variable consideration exceed the costs of doing so.

Thinking It Through — Inappropriateness of Using "Management's Best Estimate"

As previously noted, an entity is required to use one of two methods to estimate variable consideration, and management's best estimate is not one of those methods. Although we think that it is appropriate for an entity to be pragmatic in deriving an estimate by using one of the required methods, we do *not* think that it is appropriate to use a method described as management's best estimate as either the most likely amount or the expected value of variable consideration.

The Q&As below discuss practical considerations of applying the guidance in ASC 606 on estimating variable consideration.

Q&A 6-2 Selection of Method Used to Estimate Variable Consideration

ASC 606-10-32-8 requires an entity to estimate variable consideration by using either a method based on expected value (i.e., the sum of probability-weighted amounts in a range of possible consideration amounts) or a method based on the most likely amount of consideration (i.e., the single most likely outcome).

Question

Can an entity freely choose the method it uses to estimate variable consideration?

Answer

No, an entity should use whichever method will better predict the amount of consideration to which it will become entitled. When a contract has only two possible outcomes, it will often be appropriate to estimate variable consideration by using a method based on the most likely amount. When the entity has a large number of contracts with similar characteristics and the outcome for each contract is independent of the others, the expected value method may better predict the overall outcome for the contracts in the aggregate. This will be true even when each individual contract has only two possible outcomes (e.g., a sale with a right of return). This is because an entity will often have better information about the probabilities of various outcomes when there are a large number of similar transactions.

It is important, however, to consider carefully whether the outcome for each contract is truly independent of the others. For example, if the outcome is binary but is determined by the occurrence or nonoccurrence of the same event for all contracts (i.e., the variable amount will be received either for all of the contracts or for none of them), the expected value is unlikely to be a good predictor of the overall outcome and the entity may need to use the most likely amount method to estimate the variable consideration in the contracts.

Example

Each year, Entity X's performance is ranked against that of its competitors in a particular jurisdiction. All of X's customer contracts specify that a fixed bonus of $500 will be due to X if it is ranked in the top quartile. Entity X has approximately 1,000 customer contracts.

Entity X should estimate the variable consideration (i.e., the bonus) on the basis of the most likely amount. Although X has a large number of contracts, the outcomes are not independent because they all depend on the same criterion (i.e., the ranking of X against its competitors). The bonus will be payable under either all the contracts or none of them. Thus, the overall outcome for the contracts in the aggregate will be binary and the expected value will not be a good predictor of that overall outcome.

Q&A 6-3 Using More Than One Method to Estimate Variable Consideration Within One Contract

Under ASC 606-10-32-8, when the consideration promised in a contract with a customer includes a variable amount that is accounted for in accordance with ASC 606, an entity should estimate the amount of consideration to which it will be entitled by using either of the following methods: (1) expected value or (2) most likely amount. ASC 606-10-32-9 requires that an entity apply one method consistently throughout the contract and consider all reasonably available information when estimating the amount of variable consideration to which it will be entitled.

Question

When a contract contains multiple elements of variability, can an entity use more than one method (i.e., the expected value method and the most likely amount method) to estimate the amount of variable consideration to include in the transaction price?

Answer

Yes. Example 21 in ASC 606-10-55-197 through 55-200 shows that an entity should prepare a separate estimate for each element of variable consideration in a contract (i.e., for each uncertainty) by using either the expected value method or the most likely amount method, whichever method better predicts the amount of consideration to which it will be entitled.

Because ASC 606-10-32-9 requires entities to apply one method consistently to each variable element throughout the contract, it would not be appropriate to switch between the most likely amount and expected value method for a particular variable element during the life of a contract.

An entity should also consider the guidance in ASC 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether it should include some or all of the variable consideration in the transaction price.

Example

Entity X, an IT service provider, enters into a contract with a customer to develop the customer's Web site. To induce X to complete the project on a timely basis and to provide a solution that drives business growth for the customer, the fee receivable by X under the contract includes variable consideration that is determined as follows:

- One element of the fee is based on the performance of the Web site and is determined by using a sliding scale from $500,000 to $1 million. The amount earned is based on a formula that uses a number of metrics (e.g., the number of pages viewed and the number of unique visitors) measured over the two-year period after the Web site is completed and fully functional.
- The other element of the fee is based on the timely completion of the Web site and is determined as follows:
  - $1 million if the Web site is completed and fully functional within 90 days of the signing of the contract.
  - $500,000 if the Web site is completed and fully functional more than 90 days after the contract is signed.

Having considered the guidance in ASC 606-10-32-8 on selecting an appropriate method for estimating the amount of variable consideration, X applies the following methods to each element of variability in the contract:

- The amount of consideration related to the performance of the customer's Web site is estimated by using the expected value method because X estimates that it could be entitled to a wide range of possible consideration amounts (any amount between $500,000 and $1 million).
- The amount of consideration related to the timely completion of the Web site is estimated by using the most likely amount method because this element of variable consideration has only two possible outcomes ($1 million if the Web site is completed and fully functional within 90 days or $500,000 if it is completed and fully functional after more than 90 days).

Entity X should continue to use the selected method for each element consistently for the entire duration of the contract.

It is important to note the differentiation between "element of variable consideration" in Q&A 6-3 and performance obligation. The former concept refers to a unique, incremental driver of variability or uncertainty in the transaction price, while the latter concept refers to the units of account identified in step 2 (see Chapter 5). The differentiation is intended to clarify that an estimate of variable consideration is performed at the contract level and *not* at the performance obligation level. A total transaction price for the contract, including any estimates of variable consideration, must be determined in step 3 before it can be allocated in step 4 to the performance obligations identified in step 2.

As noted in Q&A 6-3, Example 21 in ASC 606 illustrates when an entity should prepare a separate estimate for each element of variable consideration in a contract.

ASC 606-10

Example 21 — Estimating Variable Consideration

55-197 An entity enters into a contract with a customer to build a customized asset. The promise to transfer the asset is a performance obligation that is satisfied over time. The promised consideration is $2.5 million, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after March 31, 20X7 that the asset is incomplete, the promised consideration is reduced by $10,000. For each day before March 31, 20X7 that the asset is complete, the promised consideration increases by $10,000.

55-198 In addition, upon completion of the asset, a third party will inspect the asset and assign a rating based on metrics that are defined in the contract. If the asset receives a specific rating, the entity will be entitled to an incentive bonus of $150,000.

55-199 In determining the transaction price, the entity prepares a separate estimate for each element of variable consideration to which the entity will be entitled using the estimation methods described in paragraph 606-10-32-8:

a. The entity decides to use the expected value method to estimate the variable consideration associated with the daily penalty or incentive (that is, $2.5 million, plus or minus $10,000 per day). This is because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.
b. The entity decides to use the most likely amount to estimate the variable consideration associated with the incentive bonus. This is because there are only 2 possible outcomes ($150,000 or $0) and it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

55-200 The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the entity should include some or all of its estimate of variable consideration in the transaction price.

TRG Update — Portfolio Practical Expedient and Estimation of Variable Consideration

There are two methods for estimating variable consideration under the new revenue standard: (1) expected value and (2) most likely amount. When an entity applies the expected value method, it may consider evidence (i.e., a portfolio of data) from other similar contracts to form its estimate of expected value. Stakeholders had raised questions to the TRG about whether the evaluation of a portfolio of data from other similar contracts in estimating an expected value of variable consideration would mean that an entity is applying the “portfolio practical expedient” discussed in Section 3.1.2.2. The concern was exacerbated by the follow-on question of whether an entity using a portfolio of data to estimate an expected value would also need to meet the necessary condition of the portfolio practical expedient that the results of doing so may not differ materially from the results of applying the guidance to the contracts individually.

The Q&As below were derived directly from the TRG’s discussion of these questions and clarify that an entity’s use of a portfolio of data from other similar contracts to calculate an estimate of the expected value of variable consideration is *not* the same as using the portfolio practical expedient.

Q&A 6-4 Using a Portfolio of Data Under the Expected Value Method to Estimate Variable Consideration

If the consideration for a contract includes a variable amount, the entity is required to estimate the amount of consideration to which it will be entitled in exchange for transferring the promised goods or services to the customer. Typical examples of variable consideration include discounts, rebates, and refunds. (See ASC 606-10-32-5 and 32-6.)

For example, assume that Entity B enters into a contract to sell Product X to Customer C for $50. Entity B's policy allows unused products to be returned within 30 days for a refund. Therefore, the contract includes variable consideration. In addition to the transaction with C, B has a large number of similar sales of Product X (i.e., a homogeneous population of contracts) with the same right of return provision.

There are two methods for estimating variable consideration under ASC 606: (1) the expected value method and (2) the most likely amount method. See Q&A 6-2 for guidance on factors to be considered in the selection of the most appropriate method in particular circumstances.

Under the expected value method, B considers a portfolio of historical data that includes contracts for Product X. Entity B concludes that this portfolio of historical data is relevant and consistent with the characteristics of the contract with C. The portfolio of data indicates that 10 out of every 100 products were returned. Using this portfolio of data, B estimates the expected value to be $45 ($50 – ($50 × 10%)) for the sale of Product X to C. That is, when a portfolio of data is used to estimate variable consideration under the expected value method, the amount estimated may not represent a possible outcome of an individual contract.

If B were to apply the most likely amount method, it would consider the two possible outcomes for this contract (i.e., $0 and $50) and estimate the variable consideration to be $50.

Question

Could an entity be required to use the expected value method to estimate variable consideration even when applying that method would not result in a possible outcome of an individual contract?

Answer

Yes. In accordance with ASC 606-10-32-8, an entity should estimate variable consideration by using whichever method will better predict the amount of consideration to which the entity will become entitled. In the example described above, when selecting which method to use to estimate variable consideration in accordance with ASC 606-10-32-8, B concludes that the expected value method will better predict the amount of consideration to which it will become entitled (see Q&A 6-2). That is, an estimate of $45 is likely to be consistent with the ultimate resolution of the uncertainty related to the product return right in these circumstances. This is because when there are a large number of similar transactions (i.e., a homogeneous population of contracts), the entity's expectation of the amount of consideration to which it will be entitled is better predicted by reference to the probabilities of outcomes exhibited by that portfolio of similar data.

Using a portfolio of data is not the same as using the portfolio practical expedient. Therefore, the restriction on using the portfolio practical expedient (i.e., the entity does not expect the results of applying ASC 606 to a portfolio of contracts with similar characteristics to be materially different from the results of applying the guidance to the individual contracts in the portfolio) does not apply (see Q&A 6-5).

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 6-5 Estimating Variable Consideration on the Basis of Historical Experience With Similar Contracts

Question

Is calculating the expected value of variable consideration on the basis of historical experience with similar contracts the same as applying the "portfolio practical expedient"[1] under ASC 606?

Answer

No. An entity's election to use a portfolio of contracts to make estimates and judgments about variable consideration (including evaluating the constraint) for a specific contract is not the same as using the portfolio approach as a practical expedient. By using a portfolio of data to make an estimate of variable consideration, an entity considers evidence from other, similar contracts to form an estimate of expected value.

Because using a portfolio of data is not the same as applying the portfolio practical expedient, the restriction on using the portfolio practical expedient (i.e., that the entity does not expect the results of applying the new revenue guidance to a portfolio of contracts to be materially different from the results of applying the guidance to individual contracts) does not apply.

The fact pattern in Q&A 6-4 illustrates this concept as follows:

- Entity B enters into a contract for the sale of Product X for $50 to Customer C. Entity B's policy allows unused products to be returned within 30 days for a refund. Therefore, the contract includes variable consideration. In addition to the transaction with C, B has a large number of similar sales of Product X (i.e., a homogeneous population of contracts) with the same right of return provision.
- Using the expected value method, B considers a portfolio of historical data that includes contracts for Product X. Entity B concludes that this portfolio of historical data is relevant and consistent with the characteristics of the contract with C. The portfolio of data indicates that 10 out of every 100 products were returned. Using this portfolio of data, B estimates the expected value to be $45 ($50 – (50 × 10%)) for the sale of Product X to C. That is, when a portfolio of data is used to estimate variable consideration under the expected value method, the amount estimated may not represent a possible outcome of an individual contract.

[1] ASC 606-10-10-4 states that an entity is permitted to use a portfolio approach as a practical expedient to account for a group of contracts with similar characteristics rather than account for each contract individually. However, an entity may only apply the practical expedient if it does not expect the results of applying the new revenue guidance to a portfolio of contracts to be materially different from the results of applying the guidance to individual contracts.

In the scenario described above, the entity is not applying the portfolio practical expedient.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

6.2.3 Constraining Estimates of Variable Consideration

Since revenue is one of the most important metrics to users of financial statements, the boards and their constituents agreed that estimates of variable consideration are only useful to the extent that an entity is confident that the revenue recognized as a result of those estimates will not be subsequently reversed. Accordingly, as noted in paragraph BC203 of ASU 2014-09, the boards acknowledged that some estimates of variable consideration should not be included in the transaction price if the inherent uncertainty could prevent a faithful depiction of the consideration to which the entity expects to be entitled in exchange for delivering goods or services. Thus, the focus of the boards' deliberations on a mechanism to improve the usefulness of estimates in revenue as a predictor of future performance was to limit subsequent downward adjustments in revenue (i.e., reversals of revenue recognized). The result of those deliberations is what is commonly referred to as the "constraint."

The constraint is thus a biased estimate that focuses on possible future downward revenue adjustments (i.e., revenue reversals) rather than on all revenue adjustments (i.e., both upward or favorable adjustments and downward or unfavorable adjustments). In paragraph BC207 of ASU 2014-09, the boards acknowledge that the constraint requirement "creates a tension with the notion of neutrality in the Boards' respective conceptual frameworks" because of the downward bias in estimation. However, the boards ultimately accepted this bias in favor of user feedback, which placed primacy on the relevance of the estimate; and in the context of revenue, the preference was for the estimate not to be subject to significant future reversals. The boards' acceptance of this bias further illustrates the decision to forgo a fair value measurement objective in the determination of the transaction price.

ASC 606-10

32-11 An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Inherent in the language of ASC 606-10-32-11 is a link between the measurement of variable consideration in the transaction price (step 3) and the recognition of an appropriate amount of revenue (step 5; see Chapter 8). That is, the constraint is naturally a measurement concept because it influences the amount of variable consideration included in the transaction price. However, its application is driven by a recognition concept and the avoidance of reversing the cumulative amount of revenue previously recognized.

During the development of the constraint guidance, its placement was debated since, as discussed in paragraph BC221 of ASU 2014-09, the boards concluded that the constraint includes concepts from both step 3 (measurement) and step 5 (recognition). Ultimately, the boards included the constraint in the measurement guidance of step 3, but the constraint guidance's wording of the phrase "a significant reversal in the amount of cumulative revenue recognized will not occur" draws on recognition concepts. As explained in paragraph BC221, the boards observed that constraining the transaction price and limiting the cumulative amount of revenue recognized "are not truly independent objectives because the measurement of revenue determines the amount of revenue recognized. In other words, the guidance for constraining estimates of variable consideration restricts revenue recognition and uses measurement uncertainty as the basis for determining if (or how much) revenue should be recognized."

ASC 606-10

32-12 In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
e. The contract has a large number and broad range of possible consideration amounts.

Inherent in ASC 606-10-32-12 are three key aspects of the assessment necessary to determine whether an estimate of variable consideration in a contract with a customer should be constrained in an entity's transaction price:

- The likelihood of a reversal in the cumulative amount of revenue recognized (i.e., a qualitative aspect).
- The magnitude (or significance) of the potential reversal in the cumulative amount of revenue recognized (i.e., a quantitative aspect).
- The threshold that triggers a constrained estimate (i.e., the use of "probable").

In paragraph BC214 of ASU 2014-09, the boards acknowledge that the application of the constraint was designed to be part of a two-step process: (1) estimate variable consideration (see Section 6.2.1) and then (2) assess whether it is probable that a significant reversal in the amount of revenue recognized from that estimate of variable consideration will occur once the underlying uncertainty is resolved. However, the boards go on to explain in paragraph BC215 that an entity is not required to perform a two-step process if the entity "already incorporates the principles on which the guidance for constraining estimates of variable consideration is based." The boards recognized that an entity may incorporate into its existing estimation processes today the qualitative principles inherent in applying the constraint. This notion is illustrated by the boards' use of the indicators in ASC 606-10-32-12, which were derived from existing, qualitative revenue guidance related to sales returns.

Further, the boards address in paragraph BC212 of ASU 2014-09 stakeholder concerns raised during the deliberations of the ASU that the application of the constraint would require a significantly quantitative process. The boards expressly acknowledge in their cost-benefit analysis of the new revenue guidance that a quantitative process is not always required, and a qualitative analysis is expected to be sufficient for applying the constraint guidance in many cases.

The term “probable” in ASC 606-10-32-11 is intended to mean that “the future event or events are likely to occur,” which is consistent with the definition in ASC 450. Paragraph 56 of IFRS 15, the IFRS counterpart of ASC 606-10-32-11, uses the term “highly probable” rather than “probable.” Since “probable” is defined in IFRS 5 as “more likely than not,” paragraph 56 of IFRS 15 uses “highly probable” to achieve the same meaning as “probable” in ASC 606-10-32-11. Therefore, despite the difference in wording, there is no difference between the intended meaning of ASC 606-10-32-11 and that of paragraph 56 of IFRS 15. For a listing of differences between ASC 606 and IFRS 15 regarding issues on which the boards could not converge, see Appendix A.

Thinking It Through — Constraining 100 Percent of an Estimate

Although the guidance on constraining estimates of variable consideration is intended to avoid significant downward adjustments in revenue after it has been recognized, we generally do not think that it would be appropriate to constrain 100 percent of an estimate of variable consideration. That is, we do not think that the factors in ASC 606-10-32-12 could be so significant that an estimate of variable consideration should be entirely constrained from the transaction price. This concept is different from a $0 *estimate* of variable consideration. A 100 percent constraint on an estimate of variable consideration that is not $0, however, would generally go against the measurement principle of ASC 606, which is to include in the transaction price the amount to which an entity expects to be entitled for its performance so that the entity can provide financial statement users a better prediction of future revenues.

While the above is a general interpretation, there are exceptions in the new revenue standard that may allow for a 100 percent constraint on an estimate of variable consideration. Example 25 in ASC 606-10-55 discusses an exception in which market-based factors are a significant driver of variability in the transaction price. Also, in paragraph BC415 of ASU 2014-09, the boards discuss their rationale for providing an exception for sales- or usage-based royalties in a license of intellectual property (IP). See Section 6.2.5.1 and Chapter 11 for further discussion of sales- or usage-based royalties.

The Q&As and Codification examples below help illustrate the intent of the guidance on constraining estimates of variable consideration.

Q&A 6-6 Constraint on Variable Consideration Assessed at the Contract Level

When determining the transaction price under ASC 606, entities are required to estimate variable consideration by using either the expected value method or the most likely amount method. ASC 606-10-32-11 states that an entity should include variable consideration in the transaction price “only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.” This limitation in the amount of variable consideration recognized is often referred to as the “constraint.” When applying the constraint, entities are required to consider both the likelihood and the magnitude of a revenue reversal.

Question

When determining the amount of variable consideration to include in the transaction price, should an entity assess the likelihood and significance of a potential revenue reversal at the performance obligation or at the contract level?

Answer

As described in Q&A 3-1, the transaction price for the contract is determined in step 3 of the revenue model and, hence, the unit of account for determining the transaction price is the contract level. The revenue constraint forms part of the determination of the transaction price; accordingly, the likelihood and significance of a potential revenue reversal should be assessed at the contract level.

Example

An entity enters into a contract with a customer to provide equipment and consulting services. The contractual price for the equipment is $10 million. The consulting services are priced at a fee of $100,000, of which $55,000 is fixed and $45,000 is contingent on the customer's reducing its manufacturing costs by 5 percent over a one-year period.

It is also concluded that:

- The equipment and consulting services are separate performance obligations.
- The stand-alone selling prices of the equipment and consulting services are $10 million and $100,000, respectively.

The entity believes that there is a 60 percent likelihood that it will be entitled to the performance-based element of the consulting services fee. As a result, by using the most likely amount approach described in ASC 606-10-32-8(b), the entity estimates the amount of the variable consideration as $45,000.

The total transaction price of the contract before the entity considers the constraint is, therefore, $10.1 million.

The entity then considers the constraint to determine whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The entity considers both the likelihood and the magnitude of a revenue reversal at the contract level.

There is a 40 percent chance that the contingent consulting services fee of $45,000 will not be receivable. Accordingly, the entity concludes that it is not probable that the entity will be entitled to the variable consideration. However, the significance of the potential revenue reversal of $45,000 is evaluated in the context of the contract ($45,000 as a proportion of $10.1 million, or 0.45 percent of the transaction price) and not in the context of the performance obligation ($45,000 as a proportion of $100,000, or 45 percent of the amount assigned to the performance obligation). Therefore, the entity concludes that all of the variable consideration should be included in the transaction price because it is probable that a significant revenue reversal will not occur.

The TRG discussed this issue in January 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 25. For additional information and Deloitte's summary, see Appendixes D and E.

ASC 606-10

Example 23 — Price Concessions

55-208 An entity enters into a contract with a customer, a distributor, on December 1, 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of $100 per product (total consideration is $100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on December 1, 20X7.

55-209 On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A — Estimate of Variable Consideration Is Not Constrained

55-210 The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 percent of the sales price for these products. Current market information suggests that a 20 percent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 percent in many years.

55-211 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be $80,000 ($80 × 1,000 products).

55-212 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $80,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $80,000) will not occur when the uncertainty is resolved (that is, when the total amount of price concessions is determined). Consequently, the entity recognizes $80,000 as revenue when the products are transferred on December 1, 20X7.

Case B — Estimate of Variable Consideration Is Constrained

55-213 The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence, and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20 to 60 percent of the sales price for similar products. Current market information also suggests that a 15 to 50 percent reduction in price may be necessary to move the products through the distribution chain.

55-214 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 percent will be provided and, therefore, the estimate of the variable consideration is $60,000 ($60 × 1,000 products).

ASC 606-10 (continued)

55-215 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of $60,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (that is, risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of $60,000 (that is, a discount of 40 percent) in the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Although the entity's historical price concessions have ranged from 20 to 60 percent, market information currently suggests that a price concession of 15 to 50 percent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $50,000 in the transaction price ($100 sales price and a 50 percent price concession) and, therefore, recognizes revenue at that amount. Therefore, the entity recognizes revenue of $50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 606-10-32-14.

Note that in the example above, it is assumed as part of the fact pattern that control of the products is transferred to the distributor at contract inception. However, the fact that the distributor becomes obliged to pay for the products only when it sells them to end customers is an indication that this might be a consignment arrangement. Consignment arrangements are discussed in Section 8.6.6.

Q&A 6-7 Cash Discounts

A seller offers a cash discount for immediate or prompt payment (i.e., earlier than required under the normal credit terms). A sale is made for $100 with the balance due within 90 days. If the customer pays within 30 days, the customer will receive a 10 percent discount on the total invoice. The seller sells a large volume of similar items on these credit terms (i.e., this transaction is part of a portfolio of similar items). The seller has elected to apply the practical expedient in ASC 606-10-32-18 and therefore will not adjust the promised amount of consideration for the effects of a significant financing component.

Question

How should the seller account for this early-payment incentive?

Answer

ASC 606 defines "transaction price" as the "amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer." This amount can vary because of discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, price concessions, or other similar items.

In the circumstances described, revenue is $100 if the discount is not taken and $90 if the discount is taken. As a result, the amount of consideration to which the entity will be entitled is variable.

Under ASC 606, if the consideration promised in a contract includes a variable amount, an entity should estimate the amount of variable consideration to which it will be entitled by (1) using either the "expected value" or the "most likely amount" method (whichever method the entity expects would better predict the amount of consideration to which it will be entitled) and then (2) considering the effect of the constraint in accordance with ASC 606-10-32-11 through 32-13.

Therefore, the seller should recognize revenue when or as the performance obligation is satisfied net of the amount of cash discount expected to be taken, measured as described above.

For example, if the discount is taken in 40 percent of transactions, the expected value will be calculated as follows:

($100 × 60%) + ($90 × 40%) = $96

If the proportion of transactions for which the discount is taken is always close to 40 percent (i.e., it is within a narrow range of around 40 percent), then it is likely that the estimate of variable consideration will not need to be constrained, and revenue of $96 will be recognized.

If, however, the proportion of transactions for which the discount is taken varies significantly, it may be necessary to apply the constraint, which will result in the recognition of less revenue. For example, historical records might show that, although the long-term average is 40 percent, there is great variability from month to month and that the proportion of transactions for which the discount is taken is frequently as high as 70 percent (but has never been higher than that). In such a scenario, the seller might conclude that only 30 percent of the variable consideration should be included, because inclusion of a higher amount might result in a significant revenue reversal. In that case, the amount of revenue recognized would be restricted to the following:

($100 × 30%) + ($90 × 70%) = $93

ASC 606-10

Example 25 — Management Fees Subject to the Constraint

55-221 On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

55-222 The entity accounts for the services as a single performance obligation in accordance with paragraph 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

55-223 At contract inception, the entity considers the guidance in paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity observes that the promised consideration is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

ASC 606-10 (continued)

55-224 At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception — the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. At March 31, 20X8, the client's assets under management are $100 million. Therefore, the resulting quarterly management fee and the transaction price is $2 million.

55-225 At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 606-10-32-28. Consequently, the entity recognizes $2 million as revenue for the quarter ended March 31, 20X8.

Q&A 6-8 Accounting for "Trail Commissions"

IA, an insurance agent, is engaged by IC, an insurance carrier, to sell IC's insurance to the general public. IA is compensated by IC on a "trail commission" basis, which means that in addition to a commission IA receives for every consumer IA signs up for IC's insurance at the time of purchase (e.g., a $100 initial commission), IA also receives from IC additional annual commissions in future years every time those consumers renew their insurance policy with IC (e.g., an additional $50 commission due upon each annual renewal of the consumer's insurance policy).

IA makes many sales to consumers on behalf of IC such that IA has a large pool of homogeneous transactions with historical information about consumer renewal patterns for insurance policies.

IA does not have any ongoing obligation to provide additional services to IC or to the consumers after the initial sale of insurance.

Question

How should IA determine the transaction price to be received from IC for each sale of insurance to a consumer?

Answer

The consideration promised in this arrangement includes both fixed and variable amounts. The initial commission of $100 due to IA upon signing up a customer is fixed consideration and is included in the transaction price. In addition, the transaction price includes variable consideration in the form of potential additional commissions due ($50 per each additional year) if and when the consumer subsequently renews the insurance policy. In accordance with the guidance in ASC 606-10-32-8, IA should estimate the variable consideration. Since IA has a large pool of homogeneous contracts on which to base its estimate, the expected value approach is used.

IA should consider evidence from other, similar contracts to develop an estimate of variable consideration under the expected value method since there is a population of data with which IA can make such an estimate.

IA will also need to consider the guidance in ASC 606-10-32-11 through 32-14 to constrain the amount of variable consideration that should be included in the transaction price. In considering the factors in ASC 606-10-32-12 that could increase the likelihood or magnitude of a significant revenue reversal, IA should use judgment and take into account all relevant facts and circumstances. This could mean looking to historical experience with similar contracts to (1) make judgments about the constraint on variable consideration and (2) estimate the amount that is not probable of a significant reversal. The greater the likelihood of a reversal of the estimated variable consideration, the greater the likelihood that the estimate should be constrained.

6.2.4 Impact of the Measurement Model for Variable Consideration

Changing Lanes — From "Fixed or Determinable" to "Expects to Be Entitled"

Under current U.S. GAAP (specifically, the SEC staff's guidance in SAB Topic 13), the amount of revenue recognized is generally limited to the amount that is not contingent on a future event (i.e., the sales price is "fixed or determinable" and no longer variable). Under step 3 of the new revenue guidance, an entity must include some or all of an estimate of variable (or contingent) consideration in the transaction price (which is the amount to be allocated to each unit of account and recognized as revenue) when the entity concludes that it is probable that changes in its estimate of such consideration will not result in significant reversals of revenue in subsequent periods. This less restrictive guidance will most likely result in earlier recognition of revenue under the new guidance than under current U.S. GAAP. Further, entities will need to exercise significant judgment when performing this assessment and could therefore find it challenging to consistently apply the requirements throughout their organization.

The model in ASC 606 for measuring variable consideration is generally considered by financial statement users to be an improvement over current revenue accounting. As discussed in Changing Lanes in Section 6.2 above, current guidance effectively requires an entity to prove its way into one of several estimation models for variable consideration; the default position is that the sales price must be fixed or determinable before it may be recognized as revenue. ASC 606 essentially flips the default into a single model *requiring* an entity to estimate variable consideration in its contracts with customers. Although more consideration may be subject to estimation under ASC 606, that is counterweighted by the comparability, across all entities, of the estimation models and methods.

6.2.5 Application to Different Forms of Variable Consideration

6.2.5.1 Sales- or Usage-Based Royalties

ASC 606-10

32-13 An entity shall apply paragraph 606-10-55-65 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of intellectual property.

ASC 606-10-55-65 states that an entity may not recognize revenue from sales- or usage-based royalties related to licenses of IP until the later of (1) the subsequent sale or usage or (2) the satisfaction of the performance obligation to which some or all of the royalty has been allocated. See Chapter 11 for further discussion of sales- or usage-based royalties related to licenses of IP.

Consideration in the form of sales- or usage-based royalties is inherently variable depending on future customer actions. However, the FASB and IASB decided that the variability in the transaction price from sales- or usage-based royalties related to licenses of IP should be accounted for differently from the variability attributable to sales- or usage-based royalties that are *not* related to licenses of IP (see Chapter 11 for further discussion of licensing). Accordingly, ASC 606-10-55-65 effectively provides that the requirements related to estimating and constraining variable consideration are subject to an exception for sales- or usage-based royalties related to licenses of IP.

It is important to note that sales- or usage-based royalties that are *not* related to licenses of IP are still subject to the requirements related to estimating and constraining variable consideration (discussed in Sections 6.2.2 and 6.2.3, respectively). In light of this, the boards acknowledge in paragraph BC416 of ASU 2014-09 that economically similar transactions could be accounted for differently (e.g., royalty arrangements not related to licenses of IP could result in timing and amounts of revenue recognition that differ from those of royalty arrangements related to licenses of IP).

6.2.5.2 Refund Liabilities

ASC 606-10

32-10 An entity shall recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, amounts not included in the transaction price). The refund liability (and corresponding change in the transaction price and, therefore, the contract liability) shall be updated at the end of each reporting period for changes in circumstances. To account for a refund liability relating to a sale with a right of return, an entity shall apply the guidance in paragraphs 606-10-55-22 through 55-29.

Refund liabilities are first introduced in the new revenue guidance as a form of variable consideration, in ASC 606-10-32-10. That is, the fact that an entity may have to refund to its customer some of the consideration it is promised in the contract is a creator of variability in the amount of consideration to which the entity is ultimately expected to be entitled in exchange for delivering the goods or services in the contract. In ASC 606-10-32-10, the FASB expressly linked the accounting for refund liabilities to their most common application, in sales with a right of return. Sales with a right of return are discussed below in Section 6.2.5.3.

Presentation of refund liabilities is further discussed in Chapter 13.

6.2.5.3 Sales With a Right of Return

ASC 606-10

55-22 In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

a. A full or partial refund of any consideration paid
b. A credit that can be applied against amounts owed, or that will be owed, to the entity
c. Another product in exchange.

ASC 606-10 (continued)

55-23 To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following:

a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
b. A refund liability
c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

55-24 An entity's promise to stand ready to accept a returned product during the return period should not be accounted for as a performance obligation in addition to the obligation to provide a refund.

In paragraph BC363 of ASU 2014-09, the FASB and IASB acknowledge that "conceptually, a contract with a right of return includes at least two performance obligations — a performance obligation [i.e., the original promise] to provide the good to the customer and a performance obligation [i.e., a secondary promise] for the return right service, which is a standready obligation to accept the goods returned by the customer during the return period." However, in paragraph BC366, the boards go on to note that their ultimate conclusions about the implementation guidance on sales with a right of return were driven by practical considerations such that the boards "decided that the incremental information provided to users of financial statements by accounting for the return right service as a performance obligation would not have justified the complexities and costs of doing so." Thus, because "standing ready" to accept returns is not regarded as a performance obligation in these circumstances, no revenue is recognized as that activity occurs. Further, as with refund liabilities, the return right service is viewed instead as a driver of variability in the amount of consideration to which the entity expects to be entitled for transferring the goods or services in the contract. See Q&A 5-3 for further discussion.

Importantly, under the boards' new revenue guidance, a sale with a right of return is not a separate variable consideration model or — as some have thought about it under current guidance — a "failed" sale model. Rather, the uncertainty associated with whether a product may be returned is treated, for measurement purposes, consistently with the uncertainty associated with whether an entity will receive all or nothing from a bonus payment of $1 million. Accordingly, the boards decided against dealing with this uncertainty through a step 5, transfer-of-control notion (i.e., a "failed" sale model). In adopting this approach, the boards chose simplicity over creating (1) several different categories of variable consideration and (2) separate measurement models for each of those separate types of variability.

As a result, although the boards provided more specific measurement and remeasurement guidance for sales with a right of return in ASC 606-10-55-25 through 55-27 (paragraphs B23 through B25 of IFRS 15), the guidance remains consistent with the standard's overall measurement principles for variable consideration.

ASC 606-10

55-25 An entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

55-26 An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

55-27 An asset recognized for an entity's right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity should update the measurement of the asset arising from changes in expectations about products to be returned. An entity should present the asset separately from the refund liability.

55-28 Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one color or size for another) are not considered returns for the purposes of applying the guidance in this Topic.

55-29 Contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties in paragraphs 606-10-55-30 through 55-35.

Common situations and identified implementation issues related to the application of the FASB's specific guidance on sales with a right of return are illustrated and discussed below in a Q&A, in Example 22 of ASC 606 (reproduced from the Codification), and in a TRG Update (which includes a Q&A).

Q&A 6-9 Estimating the Transaction Price When an Entity Promises to Stand Ready to Accept a Returned Product During the Return Period and Provide a Refund

Entities often offer customers the right to return a product within a certain period after its initial sale, provided that the product has not been used or damaged.

Question

How should an entity estimate the transaction price when the entity promises to stand ready to accept a returned product during the return period and provide a refund?

Answer

The transaction price should be estimated in the same way as any other variable consideration (see Example 22 in ASC 606-10-55-202 through 55-207 below) and should reflect the amount to which the entity expects to be entitled, which should be adjusted to exclude amounts expected to be reimbursed or credited to customers by using either the most likely amount or the expected value method (as discussed in Q&A 6-3).

For example, when a retail store has a policy that allows customers to return a product within 30 days (for any reason), no amount of the transaction price is allocated to the "service" of standing ready to accept the returned product. Instead, the transaction price is estimated and constrained to the amount for which the entity expects it is probable that significant reversal will not occur when the uncertainty associated with expected returns is resolved. An adjustment to revenue will then be recognized when the level of returns is known after 30 days or by updating the estimated transaction price as of any reporting date falling within that period.

ASC 606-10

Example 22 — Right of Return

55-202 An entity enters into 100 contracts with customers. Each contract includes the sale of 1 product for \$100 (100 total products × \$100 = \$10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is \$60.

55-203 The entity applies the guidance in this Topic to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 606-10-10-4, the effects on the financial statements from applying this guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within the portfolio.

55-204 Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

55-205 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of \$9,700 (\$100 × 97 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (that is, the 30-day return period). Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$9,700) will not occur as the uncertainty is resolved (that is, over the return period).

55-206 The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

55-207 Upon transfer of control of the 100 products, the entity does not recognize revenue for the 3 products that it expects to be returned. Consequently, in accordance with paragraphs 606-10-32-10 and 606-10-55-23, the entity recognizes the following:

Cash	10,000 (\$100 × 100 products transferred)	
Revenue		9,700 (\$100 × 97 products not expected to be returned)
Refund liability		300 (\$100 refund × 3 products expected to be returned)

Cost of sales	5,820 (\$60 × 97 products not expected to be returned)	
Asset	180 (\$60 × 3 products for its right to recover products from customers on settling the refund liability)	
Inventory		6,000 (\$60 × 100 products)

TRG Update — Accounting for Restocking Fees and Related Costs

Stakeholders raised questions regarding the appropriate accounting for restocking fees collected from customers and restocking costs (e.g., estimated shipping or repackaging) for expected returns. Consider the following Q&A:

Q&A 6-10 Restocking Fees and Related Costs

In some industries, customers are not entitled to a full refund if they return a previously purchased product to the seller. In effect, the seller charges a fee for accepting returns, sometimes referred to as a "restocking" fee. Restocking fees are typically stated in the contract between the seller and the customer.

Restocking fees can serve a number of purposes for the seller, including (1) to recover some of the costs the seller expects to incur in returning such product to saleable inventory (e.g., repackaging or shipping costs), (2) to mitigate a potential reduced selling price upon resale, and (3) to discourage customers from returning products.

Question

How should an entity account for the restocking fees it receives and the costs it expects to incur for products returned by a customer?

Answer

Restocking fees for expected returns should be included as part of the transaction price; the entity will need to consider the guidance in ASC 606-10-32-5 through 32-9 on estimating variable consideration.

In accordance with ASC 606-10-55-27, the costs expected to be incurred when the products are returned should be recognized as of the date on which control is transferred to the customer as a reduction of the carrying amount of the asset expected to be recovered.

Example

Entity X enters into a contract with Customer Y to sell 10 widgets for $100 each in cash. The cost of each widget to X is $75. Customer Y has the right to return a widget but will be charged a restocking fee of 10 percent (i.e., $10 per widget). Entity X expects to incur costs of $5 per widget to ship and repackage each item returned before it can be resold.

Entity X concludes that because a right of return exists, the consideration promised under the contract includes a variable amount. Entity X uses the expected value method for estimating the variable consideration and estimates that (1) 10 percent of the widgets will be returned and (2) it is probable that returns will not exceed 10 percent. Entity X also expects that the returned widgets can be resold at a profit.

Example (continued)

When control of the 10 widgets is transferred to the customer, X therefore recognizes revenue of $900 for 9 widgets sold ($100 × 9) and also includes the restocking fee for 1 widget of $10 ($100 × 10%) in the transaction price. Entity X also recognizes a refund liability of $90 for the 1 widget that is expected to be returned ($100 transaction price less $10 restocking fee). This analysis is reflected in the following journal entry:

Cash	1,000	
Revenue		910
Refund liability		90

On the cost side:

In accordance with ASC 606-10-55-27, X recognizes an asset for its right to recover the widget from Y on settlement of the refund liability. The asset is measured at the former carrying amount of the inventory items as reduced by the expected costs to recover the product. Entity X therefore recognizes an asset of $70 ($75 cost less $5 restocking cost).

The cost of sales is $680, which is the aggregate of (1) the cost of items sold and not expected to be returned of $675 (9 widgets × $75) and (2) the anticipated restocking cost of $5.

This cost analysis is reflected in the following journal entry:

Products expected to be returned (asset)	70	
Cost of sales	680	
Inventories		750

When the widget is returned by Y, $90 is refunded. The widget is returned to inventory. Entity X incurs the restocking cost and includes that cost in the inventory amount as follows:

Refund liability	90	
Cash (refund paid to customer)		90
Inventories	75	
Products expected to be returned		70
Cash (payment of restocking costs)		5

The TRG discussed this issue in July 2015; a summary of The TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

6.2.5.4 *Variable Consideration Driven by Variable Volumes*

TRG Update — Customer Options for Additional Goods or Services

Under the new revenue standard, an entity must determine its contractual rights and obligations, including whether options for future goods or services give rise to performance obligations under a current contract with a customer (see Section 5.6). In considering how to apply the guidance on optional purchases for which an entity does not identify a material right, stakeholders have questioned whether and, if so, when customer options to acquire additional goods or services would be considered (1) a separate contract that arises when the option is exercised or (2) variable consideration for which an entity would be required to estimate the amount of consideration to include in the original contract's transaction price (subject to the standard's constraint on variable consideration). That is, stakeholders have raised questions about when an entity, as part of determining its transaction price, should estimate customers' future purchases that may be made under options for additional goods or services.

TRG members discussed the issue of whether and, if so, when an entity would be required to estimate future purchases in a current contract with a customer. They reiterated the view that the new revenue standard does not require an entity to estimate the transaction price of future contracts into which it will enter with a customer. In addition, they expressly noted that their view is supported by the FASB and IASB in paragraph BC186 of ASU 2014-09, which states that "the transaction price should include only amounts (including variable amounts) to which the entity has rights under the **present** contract" (emphasis added).

Further, TRG members generally agreed with the framework outlined by the FASB and IASB staffs, under which an entity would perform an evaluation of the nature of its promises in a contract with a customer, including a careful evaluation of the enforceable rights and obligations in the present contract (not future contracts). That is, there is a distinction between (1) customer options and (2) uncertainty that is accounted for as variable consideration. Customer options are predicated on a separate customer action (namely, the customer's decision to exercise the option), which would not be embodied in the present contract; unless an option is a material right, such options would not factor into the accounting for the present contract. Uncertainty is accounted for as variable consideration when the entity has enforceable rights and obligations under a present contract to provide goods or services without an additional customer decision. The Q&As below expand on this framework.

The TRG also generally agreed with the view that enforceable rights and obligations in a contract are only those for which the entity has legal rights and obligations under the contract and would not take economic or other penalties into account (e.g., (1) economic compulsion or (2) exclusivity because the entity is the sole provider of the goods or services, which may make the future deliverables highly probable of occurring). Q&A 5-16 further expands on this view.

Q&A 6-11 Distinguishing Between Optional Purchases and Variable Consideration

Under ASC 606, if an entity has entered into a contract that includes uncertainty because of an option for a customer to obtain "additional goods or services," the entity needs to evaluate that option to determine whether it represents a material right. If the option represents a material right, part of the transaction price is allocated to that material right, and recognition of a portion of revenue is deferred (see ASC 606-10-55-41 through 55-45). Such additional goods or services are not themselves performance obligations under the contract; instead, the option to acquire them is treated as a performance obligation if it represents a material right.

ASC 606 deals separately with the appropriate accounting for “variable consideration” when the consideration promised in a contract includes a variable amount (see ASC 606-10-32-5 through 32-14). For example, there may be uncertainty in a long-term contract that includes optional or variable consideration because of other factors (e.g., variable quantities that affect the consideration due under the contract). Entities should take variability of this nature into account in determining the transaction price.

Question

If quantities of goods or services to be delivered under a contract are not fixed at the outset but will instead be determined later, how should an entity determine whether those goods or services are “additional goods or services” as contemplated in ASC 606-10-55-41 (which may represent a material right under the contract) or variable consideration (so that variability is included in the transaction price)?

Answer

An entity will need to evaluate the nature of its promises under a contract and use judgment to determine whether the contract includes (1) an option to purchase additional goods or services (which the entity would need to evaluate for a material right) or (2) a performance obligation for which the quantity of goods or services to be delivered is not fixed at the outset (which would be treated as variable consideration).

In exercising such judgment, an entity may find the following indicators helpful:

- A determination that an entity’s customer can make a separate purchasing decision with respect to additional distinct goods or services and that the entity is not obliged to provide those goods or services before the customer exercises its rights would be indicative of an option for additional goods or services. For example, suppose that an entity enters into a five-year exclusive master supply agreement with a customer related to components that the customer uses in its products. The customer may purchase components at any time during the term of the agreement, but it is not obliged to purchase any components. Each time the customer elects to purchase a component from the entity represents a separate performance obligation of the entity.
- Conversely, if future events (which may include a customer’s own actions) will not oblige an entity to provide a customer with additional *distinct* goods or services, any additional consideration triggered by those events would be accounted for as variable consideration. For example, suppose that an entity agrees to process all transactions for a customer in exchange for fees that are based on the volume of transactions processed, but the volume of transactions is not known at the outset and is outside the control of both the entity and the customer. The performance obligation is to provide the customer with continuous access to transaction processing for the contract period. The additional transactions processed are not distinct services; rather, they are part of the satisfaction of the single performance obligation to process transactions.

The TRG discussed this issue in November 2015; a summary of the TRG’s discussion is available in TRG Agenda Paper 49. For additional information and Deloitte’s summary, see Appendixes D and E.

Contracts regularly include adjustments to the price based on volumes acquired. Those pricing features would be accounted for as variable consideration. See the Q&A and Codification example below.

Q&A 6-12 Volume-Based Rebates Applied Retrospectively and Prospectively

An entity may offer its customers rebates or discounts on the pricing of products or services once specific volume thresholds have been met. That is, an entity may either retrospectively or prospectively adjust the price of its goods or services once a certain volume threshold has been met.

Question 1

Should an offer to **retrospectively** lower the price per unit (once certain volume thresholds are met) be accounted for as variable consideration (rather than a customer option to be evaluated as a potential material right)?

Answer

Yes. A volume rebate or discount that is **retrospectively** applied should be accounted for as variable consideration under ASC 606. In accordance with ASC 606-10-32-6, which specifically includes discounts and rebates as a form of variable consideration, the "promised consideration also can vary if an entity's entitlement to the consideration is **contingent on the occurrence or nonoccurrence of a future event**" (emphasis added).

Question 2

Should an offer to **prospectively** lower the price per unit (once certain volume thresholds are met) be accounted for as variable consideration (rather than a customer option to be evaluated as a potential material right)?

Answer

No. When a volume rebate or discount is applied **prospectively**, entities will need to evaluate the facts and circumstances of each contract to determine whether the rebate or discount represents a material right and therefore should be accounted for as a performance obligation. As part of this evaluation, entities would consider whether the offer to the customer is at a price that would reflect the stand-alone selling price for that good or service, in accordance with ASC 606-10-55-43.

Example 1

Rebate Applied Retrospectively

Entity X enters into a contract with a customer to supply widgets. Under the terms of the contract, each widget is sold for $10, but if the customer purchases more than 100 widgets in a calendar year, the price will be reduced retrospectively to $8 per widget. The contract does not include any minimum purchase commitments.

In this example, the volume rebate of $2 is applied retrospectively. It should be accounted for as variable consideration under ASC 606-10-32-5 through 32-14 because X's entitlement to consideration for each unit sold is contingent on the occurrence of a future event (i.e., the customer's buying more than 100 units).

Example 1 (continued)

Accordingly, X is required to estimate the amount of consideration to which it will be entitled for each widget by using either the expected value method or the most likely amount (whichever is considered to better predict the amount of consideration to which X will be entitled). The $2 variable consideration should only be included in the transaction price if it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur (i.e., it is likely that the customer will not purchase more than 100 units).

Example 24 in the new revenue standard (ASC 606-55-216 through 55-220) illustrates how an entity would account for a volume discount incentive as variable consideration.

Example 2

Rebate Applied Prospectively

Entity Y enters into a contract with a customer to supply widgets. Under the terms of the contract, each widget is sold for $10, but if the customer purchases more than 100 widgets in a calendar year, the price will be reduced prospectively to $8 per widget (i.e., the $8 price applies only for subsequent purchases). The contract does not include any minimum purchase commitments.

In this example, the customer has an option to purchase additional widgets at a reduced price of $8 per unit, which should be accounted for in accordance with ASC 606-10-55-41 through 55-45. Entity Y will need to evaluate the facts and circumstances to determine whether the option gives rise to a performance obligation. The option would give rise to a performance obligation if it provides a material right to the customer that the customer would not receive without purchasing the first 100 units. As part of this evaluation, Y should consider whether the reduced price offered to the customer ($8 per unit) reflects the stand-alone selling price for the widgets, in accordance with ASC 606-10-55-43.

ASC 606-10

Example 24 — Volume Discount Incentive

55-216 An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for $100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to $90 per unit. Consequently, the consideration in the contract is variable.

55-217 For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

55-218 The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

55-219 In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to $90.

55-220 Consequently, the entity recognizes revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

6.2.5.5 Other Forms of Variability

The Q&As below discuss other common forms of variability in the transaction price and how those forms of variability would be accounted for under the guidance in ASC 606 on estimating (and potentially constraining) variable consideration.

Q&A 6-13 Contracts That Include Consideration in a Foreign Currency

In determining the transaction price for a contract with a customer under ASC 606, an entity is required to measure the amount of consideration to which it expects to be entitled in exchange for goods or services. The consideration may be fixed, variable, or a combination of both. ASC 606-10-32-6 notes that an "amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items" or because an "entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event."

Question

Should the variability arising because consideration is receivable in a currency other than the entity's functional currency be accounted for as variable consideration in accordance with ASC 606-10-32-5 through 32-9?

Answer

No. Despite the broad definition of variable consideration in ASC 606, consideration that is fixed in a foreign currency should not be considered variable consideration. This is because the amount of consideration promised in the contract does not vary; instead, that fixed amount of consideration is retranslated into a variable amount of the entity's functional currency.

Therefore, an entity is not required to consider whether potential future adverse movements in the exchange rate could result in a requirement to limit the amount of revenue recognized in accordance with ASC 606-10-32-11. Instead, the principles of ASC 830 should be applied.

Q&A 6-14 Accounting for Liquidating Damage Obligations

Some contracts provide for liquidating damages or similar features that specify damages in the event that the vendor fails to deliver future goods or services or the vendor's performance fails to achieve certain specifications.

Question

Should liquidating damages, penalties, or other similar features be evaluated as variable consideration under ASC 606?

Answer

Yes, with limited exceptions. Most liquidating damage clauses, penalties, and other similar features will be accounted for as variable consideration under ASC 606-10-32. This is illustrated in Example 20 in ASC 606-10-55-194 through 55-196. However, an entity must consider the specific facts and circumstances in coming to this conclusion.

In limited situations, consideration paid to a customer that is required under a warranty or similar claim may be accounted for in a manner consistent with the warranty guidance under ASC 606-10-55-30 through 55-35. Under ASC 606-10-32-25 through 32-27, consideration paid to a customer is a reduction of the transaction price unless the payment is in exchange for a distinct good or service. There may be limited situations in which the consideration paid to a customer is intended to reimburse the cost of warranty services that the customer has incurred directly and that the vendor would have otherwise been obligated to provide to the customer. In these limited instances, it would be appropriate to account for the reimbursement amount paid to the customer as an assurance- or service-type warranty.

Example

An entity sells a product to its customer. Shortly after the purchase (within the warranty period), the product does not perform as intended because of a malfunctioning part. The customer pays a third-party contractor $100 to fix the malfunctioning part. In accordance with the warranty terms of the contract, the entity reimburses the customer for the cost of the third-party repairs ($100).

The cash reimbursement amount paid to the customer is based on the cost of repair of the product and is in accordance with the standard warranty terms of the product. The vendor should account for the repair cost as an assurance-type warranty cost in accordance with ASC 606-10-55-32. As a result, the $100 is presented as an expense rather than a reduction of revenue.

6.2.6 Reassessment of Variable Consideration

ASC 606-10

32-14 At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 606-10-32-42 through 32-45.

After its initial estimate (and potential constraint) of variable consideration at contract inception, an entity must reassess that estimate (and potential constraint) at the end of each reporting period as the uncertainties underlying the variable consideration are resolved or more information about the underlying uncertainties is known. As noted in paragraph BC224 of ASU 2014-09, the FASB and IASB "decided that an entity should update its estimate of the transaction price throughout the contract [because] reflecting current assessments of the amount of consideration to which the entity expects to be entitled will provide more useful information to users of financial statements."

However, like the assessment of the transaction price at contract inception, reassessment of the transaction price is part of a three-step process for recognizing revenue. That is, once an entity updates an estimate (and potential constraint) of variable consideration after inception, it generally must reallocate the transaction price in accordance with step 4, in the same proportions used in the allocation of the transaction price at inception, to the performance obligations identified in step 2 so that revenue can be recognized in step 5 when (or as) the entity satisfies a performance obligation. The example below illustrates how this guidance would be applied.

Example 6-1

Assume that an entity enters into a contract with a customer for the delivery of three performance obligations, PO1, PO2, and PO3. The consideration in the contract is wholly variable, and the entity's estimate of variable consideration at contract inception is $300. The entity determines that a constraint of its estimate of variable consideration is unnecessary. The stand-alone selling prices of the three performance obligations are as follows:

- PO1 = $100.
- PO2 = $200.
- PO3 = $300.

Accordingly, the entity allocates the estimate of variable consideration to the performance obligations on a relative stand-alone selling price basis as follows:

- PO1 = $100 ÷ $600 × $300 = $50.
- PO2 = $200 ÷ $600 × $300 = $100.
- PO3 = $300 ÷ $600 × $300 = $150.

If the uncertainty in the contract consideration is subsequently resolved and the entity determines that the updated transaction price is $600, the entity reallocates the updated transaction price to the performance obligations in proportion to their relative stand-alone selling prices at inception as follows:

- PO1 = $100 ÷ $600 × $600 = $100.
- PO2 = $200 ÷ $600 × $600 = $200.
- PO3 = $300 ÷ $600 × $600 = $300.

The accounting for a change in the transaction price, including the guidance in ASC 606-10-32-42 through 32-45 on reallocating that change, is further discussed in Section 7.4.

6.3 Significant Financing Component

In certain contracts with customers, one party may provide a service of financing (either explicitly or implicitly) to the other. Such contracts effectively contain two transactions: one for the delivery of the good or service and another for the benefit of financing (i.e., what is in substance a loan payable or loan receivable). The FASB and IASB decided that an entity should account for both transactions included in a contract with a customer when the benefit of the financing provided is significant.

ASC 606-10

32-15 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

In paragraph BC230 of ASU 2014-09, the boards note that the "objective of adjusting the promised amount of consideration for the effects of a significant financing component is to reflect, in the amount of revenue recognized, the 'cash selling price' of the underlying good or service at the time that the good or service is transferred." This objective is consistent with the intent of the allocation guidance in step 4 (see Chapter 7) in that the goal is to arrive at an amount of revenue recognized that reflects the value of the goods or services transferred to the customer. If an entity were to ignore a significant financing component included in a contract, the revenue recognized from, and the cash flows associated with, the contract with the customer could be misrepresented to users in the entity's financial statements. That is because the second service (namely, the financing) would not be reflected in the financial statements.

6.3.1 Practical Expedient Providing Relief From the Significant Financing Component Guidance

Under current U.S. GAAP, an entity is generally not required to recognize the effects of financing if the time period of such benefit is within customary trade terms of less than a specified period (usually one year) and the receivable or payable arises from a customer in the normal course of business. In ASC 835-30, an entity is exempted from imputing interest on a receivable if the transaction with the customer is (1) in the normal course of business and with customary terms and (2) for one year or less. In developing the new revenue standard, the FASB and IASB determined that the benefits to financial statement users of changing current practice and requiring an entity to account for the effects of significant financing when the period is for less than a year did not exceed the costs to preparers.

Accordingly, the boards decided to grant a practical expedient in ASC 606-10-32-18 (paragraph 63 of IFRS 15) for financing components when the duration of the financing (i.e., the time between the transfer of control of the goods or services and when the customer pays for them) is one year or less. In paragraph BC236 of ASU 2014-09, the boards acknowledge that they provided the practical expedient as part of efforts to simplify the application of the new revenue guidance for financial statement preparers even though the expedient could produce undesirable reporting outcomes (e.g., when a one-year contract provides financing that is material to the contract's value because of a relatively high interest rate).

ASC 606-10

32-18 As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

ASC 606-10

50-22 If an entity elects to use the practical expedient in either paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a contract), the entity shall disclose that fact.

As indicated in ASC 606-10-10-3 and ASC 606-10-50-22 (the latter of which is reproduced above), an entity that elects to use this practical expedient should (1) apply it consistently to contracts with similar characteristics and in similar circumstances and (2) disclose such election.

Changing Lanes — Time Value of Money

The following table compares the accounting for the time value of money under legacy U.S. GAAP with that under ASC 606:

Legacy U.S. GAAP	ASC 606
• Interest should be imputed for receivables arising from transactions with customers in the normal course of business that are due in customary trade terms exceeding approximately one year. • There is no requirement for entities to recognize interest on advance payments received from transactions with customers.	• In determining the transaction price, an entity adjusts the promised amount of consideration to determine the cash selling price of the good or service to be delivered and reflect the time value of money *if* the contract has a significant financing component. The direction of the financing component (i.e., whether financing provided to the entity through an advance payment or to the customer through payments in arrears) is irrelevant to the assessment, and as a result of the adjustment to the transaction price, the entity could recognize interest expense or interest income. As discussed in Section 6.3.2 below, the model includes factors to be considered in the evaluation of whether the financing component is significant. • An entity does not need to apply the time value of money provisions when the period between payment and the transfer of goods or services is one year or less.

6.3.2 Existence and Significance of a Financing Component

ASC 606-10

32-16 The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
b. The combined effect of both of the following:
    1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
    2. The prevailing interest rates in the relevant market.

An entity is required to assess the factors in ASC 606-10-32-16 to determine the existence of a significant financing component for the following reasons:

- As noted in paragraph BC232 of ASU 2014-09, the fact that an entity sells the goods or services in the contract with the customer at varying prices depending on the timing of the payment terms will generally provide both parties to the contract with relatively observable data to support a determination that the entity's contracts with customers contain a financing component (and that the entity needs to adjust the transaction price to determine the cash selling price of the goods or services to be delivered).

- If there is an alignment between the duration of the financing provided in the contract and the market interest rates available for a financing of that duration, there is a strong indication that the parties intend to include a financing transaction in the contract.

However, in the assessment of the factors noted above, a question arises about whether the "significance" of a financing component should be in the context of the associated performance obligation, the individual contract, or a portfolio of similar contracts. The Q&As below further discuss the considerations inherent in an assessment of the existence and significance of a financing component in a contract with a customer.

Q&A 6-15 Assessing the Significance of a Financing Component

ASC 606-10-32-15 requires an entity to adjust the promised amount of consideration for the effects of the time value of money if the contract contains a "significant" financing component.

Question

Should the assessment of significance be made in the context of the associated performance obligation, the individual contract, or a portfolio of similar contracts?

Answer

The significance of a financing component should be assessed in the context of the individual contract.

ASC 606-10-32-16 specifically requires an entity to consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is *significant to the contract*. Consequently, the significance of a financing component should be assessed in the context of the individual contract rather than, for example, a portfolio of similar contracts or at a performance-obligation level.

The basis of this requirement is explained in paragraph BC234 of ASU 2014-09, which states:

> 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.

As a consequence, some financing components will not be identified as significant — and, therefore, the promised amount of consideration would not be adjusted — even though they might be material in aggregate for a portfolio of similar contracts.

Although a financing component can only be *quantified* after individual performance obligations are considered, the *significance* of a financing component is not assessed at the performance-obligation level. To illustrate, an entity may typically sell Product X, for which revenue is recognized at a point in time, on extended credit terms such that, when Product X is sold by itself, the contract contains a significant financing component. The entity may also sell Product X and Product Y together in a bundled contract, requiring the customer to pay for Product Y in full at the time control is transferred but granting the same extended credit terms for Product X.

If the value of Product Y is much greater than the value of Product X, any financing component for Product X may be too small to be assessed as significant in the context of the larger bundled contract. Therefore, in such circumstances, the entity (1) would adjust the promised consideration for a significant financing component when Product X is sold by itself but (2) would not need to adjust the promised consideration for a significant financing component when Product X is sold together with Product Y in a single contract.

Q&A 6-16 Assessing a Significant Financing Component When Consideration to Be Received Is Equal to Cash Selling Price

ASC 606-10-32-16 notes that the "difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services" is one of the factors relevant to an assessment of whether a significant financing components exists.

In some situations, the implied interest rate in an arrangement is zero (i.e., interest-free financing) such that the consideration to be received at a future date is equal to the cash selling price (i.e., the amount that would be received from a customer who chooses to pay for the goods or services in cash when (or as) they are delivered).

Question

In the situations in which the future amount of consideration to be received is equal to the cash selling price, does this in itself demonstrate that the contract does not contain a significant financing component?

Answer

No. In such circumstances, it should not automatically be assumed that the contract does not contain a significant financing component. A difference between the amount of promised consideration and the cash selling price is only one of the indicators that an entity should consider in determining whether there is a significant financing component.

The fact that an entity provides what appears to be zero-interest financing does not necessarily mean that the cash selling price is the same as the price that would have been paid by another customer who has opted to pay over time. Accordingly, an entity may need to use judgment when determining a cash selling price for a customer who pays over time.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 6-17 Requirement to Discount Trade Receivables

Entity B, a retailer, offers interest-free financing to its customers. Depending on the type of product purchased, the financing arrangement gives the customer interest-free financing for a period of 12, 15, or 18 months. The customer pays equal monthly installments from the date of purchase over the financing period. This is common industry practice in the country where B is located, and other retailers offer similar financing arrangements; no recent cash transactions are available from which B can make a reliable estimate of the cash sales price. On the basis of prevailing interest rates in the relevant market, B estimates that the customer would be able to borrow from other sources at an interest rate of 18 percent.

In accordance with ASC 606-10-32-16(b), B believes that as a result of the combination of (1) the length of time between the transfer of the good and payment and (2) the high interest rates at which the customer can obtain financing, the arrangement contains a significant financing component.

Question

Is B required to adjust the transaction prices in all of its interest-free financing sale arrangements to reflect the effects of the time value of money?

Answer

In accordance with ASC 606-10-32-15, entities are required to adjust the promised amount of consideration, even when a significant financing component is not explicitly identified in the contract. However, ASC 606-10-32-18 provides a practical expedient for contracts with a significant financing component when the period between the transfer of goods and the customer's payment is, at contract inception, expected to be one year or less.

Consequently, in the circumstances described, B is required to adjust the sales price for all arrangements other than those with a contractual period of 12 months or less. For arrangements with a contractual period of 12 months or less, B is permitted to adjust the sales price when it identifies a significant financing component, which it may wish to do to align with its other contracts; however, it is not required to do so.

If B takes advantage of the practical expedient under ASC 606-10-32-18, it is required to do so consistently in similar circumstances for all contracts with similar characteristics.

6.3.3 Circumstances That Do Not Give Rise to a Significant Financing Component

In paragraph BC231 of ASU 2014-09, the FASB and IASB acknowledge that the mere separation between the timing of delivery and the timing of payment does not always mean that a benefit of financing has been provided in the contract. That is, there are other economically substantive reasons for the existence of a significant period between delivery and payment. In light of this, the boards wanted to reflect in paragraph BC232 of ASU 2014-09 their intent for entities to account for a significant financing and not the time value of money, which has a broader economic context than just the benefit of a financing. To further emphasize this distinction, the boards also provided indicators in ASC 606-10-32-17 (paragraph 62 of IFRS 15) of circumstances in which a difference in timing between delivery and payment does not require an entity to adjust the transaction price to reflect the cash selling price of the good or service delivered.

ASC 606-10

32-17 Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).
c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

The boards describe in paragraph BC233 of ASU 2014-09 a number of examples they had in mind when considering the factors included in ASC 606-10-32-17 (paragraph 62 of IFRS 15):

Advance payment and timing of transfer are at discretion of customer.	Prepaid cell phone cards.
	Customer loyalty programs.
Consideration is variable depending on events outside the control of either party.	Royalty arrangements, in which variability is provided to confirm the value of goods delivered.
Difference between cash selling price and promised consideration is for nonfinance reasons.	Customer withholds consideration until the achievement of a certain milestone and to protect against nonperformance.
	Customer required to pay up front to secure supply of a good.

Thinking It Through — Advance Payment Versus Deferred Payment

It is important to note that the examples considered by the boards in paragraph BC233 of ASU 2014-09 illustrate a number of instances in which an advance payment is in return for something other than financing but illustrate only a limited instance in which a deferred payment is in return for something other than financing. We think that this disparity indicates that the boards thought that there are few real-life scenarios in which an entity would allow for a deferred payment from a customer for reasons other than to provide the customer with the benefits of financing. Accordingly, we think that it would generally be easier to align the indicators in ASC 606-10-32-17 with a contract that contains an advance payment and harder to align the indicators with a contract that contains a deferred payment.

TRG Update — How to Evaluate a Material Right for the Existence of a Significant Financing Component

TRG members indicated that they would generally view a customer's exercise of a material right as a continuation of the initial contract. However, they could also understand why others might view such an exercise as a contract modification depending on the facts and circumstances. TRG members also noted that while the determination of whether there is a significant financing component (associated with the material right) depends on the facts and circumstances, entities would need to evaluate material rights for the existence of significant financing components in a manner similar to how they would evaluate any other performance obligation. That is, there is no safe harbor that a material right would not have a significant financing component.

The Q&As and Codification examples below further build on the foundation laid in ASC 606-10-32-16 and 32-17 for assessing when it is appropriate to adjust the transaction price for a significant financing component and to reflect the cash selling price of the good or service to be delivered.

Q&A 6-18 Determining Whether There Is a Significant Financing Component

ASC 606-10-32-15 requires an adjustment for the effects of the time value of money if "the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing."

Question

Is there a presumption in ASC 606 that there is a significant financing component when there is a difference in timing between when goods or services are transferred and when the promised consideration is paid?

Answer

No. ASC 606-10-32-17(c) states that a contract would not have a significant financing component if the difference between the promised consideration and the cash selling price of the goods or services "arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference."

An entity should use judgment to determine (1) whether the payment terms are intended to provide financing or are for another valid reason and (2) whether the difference between the promised consideration and the cash selling price of the goods or services is proportional to that reason.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

ASC 606-10

Example 27 — Withheld Payments on a Long-Term Contract

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.

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 specific percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

ASC 606-10

Example 30 — Advance Payment

55-244 An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional $300. Customers electing to buy this service must pay for it upfront (that is, a monthly payment option is not available).

55-245 To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximize profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

55-246 In assessing the guidance in paragraph 606-10-32-17(c), the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Q&A 6-19 Financing Components That Are Not Significant

ASC 606-10-32-16 and 32-17 provide guidance on how an entity should assess whether a contract contains a significant financing component. When an entity concludes that a significant financing component exists, the entity is required under ASC 606-10-32-15 to adjust the promised consideration for the effects of the time value of money in its determination of the transaction price.

Question

Does ASC 606 preclude accounting in this manner for financing components that are not determined to be significant?

Answer

No. While there is no requirement for an entity to adjust for the time value of money when the financing component is not considered to be significant, there is nothing to preclude an entity from applying ASC 606-10-32-16 and 32-17 in such circumstances.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

6.3.4 Determining the Discount Rate

In paragraph BC238 of ASU 2014-09, the FASB and IASB discuss an example in which an entity is receiving financing from a customer through an advance payment instead of obtaining that financing from a third party (e.g., a bank). The entity needs to obtain financing before it can perform its obligations under the contract with its customer. The boards note in discussing this example that the resulting financial reporting for the entity's revenue in the contract with the customer should not differ depending on the source of the financing. The same can be said of the intent of the boards' guidance in ASC 606-10-32-19 (paragraph 64 of IFRS 15) for determining the discount rate an entity should use to measure the significant financing component and adjust the promised consideration in the contract to the cash selling price.

ASC 606-10

32-19 To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

In their deliberations, the boards considered requiring the use of either a risk-free rate or the rate explicitly specified in the contract with the customer. However, as noted in paragraph BC239 of ASU 2014-09, the boards reasoned that neither alternative would reflect the economics of the financing provided or the appropriate profit margin built into the contract (e.g., the entity could specify a "free financing" rate as a marketing incentive, which would be inappropriate for the entity to use in determining the transaction price). Consequently, as indicated in ASC 606-10-32-19 (paragraph 64 of IFRS 15), the boards decided that an entity should "use the discount rate that would be reflected in a separate financing transaction between the entity and its customer."

Because of the practical expedient in ASC 606-10-32-18 (paragraph 63 of IFRS 15) and the indicators provided of when a significant benefit of financing is not being provided to a party in the contract, the boards reason in paragraph BC241 of ASU 2014-09 that "in those remaining contracts in which an entity is required to account separately for the financing component, the entity and its customer will typically negotiate the contractual payment terms separately." That is, in many circumstances in which there is an identified significant financing component that affects the transaction price, the entity will have access in the negotiation process to information about the discount rate implied in the arrangement.

The Codification examples and Q&As below illustrate how an entity would determine the discount rate when adjusting the amount of consideration received in a significant financing arrangement.

ASC 606-10

Example 28 — Determining the Discount Rate

55-235 An entity enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is $1 million plus a 5 percent contractual rate of interest, payable in 60 monthly installments of $18,871.

Case A — Contractual Discount Rate Reflects the Rate in a Separate Financing Transaction

55-236 In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent reflects the credit characteristics of the customer).

55-237 The market terms of the financing mean that the cash selling price of the equipment is $1 million. This amount is recognized as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with Topic 310 on receivables {, Subtopic 326-20 on financial instruments measured at amortized cost,} and Subtopic 835-30 on the imputation of interest.

Case B — Contractual Discount Rate Does Not Reflect the Rate in a Separate Financing Transaction

55-238 In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest is significantly lower than the 12 percent interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than $1 million.

55-239 In accordance with paragraph 606-10-32-19, the entity determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 12 percent interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is $848,357 (60 monthly payments of $18,871 discounted at 12 percent). The entity recognizes revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with Topic 310 {Subtopic 310-10} on receivables {, Subtopic 326-20 on financial instruments measured at amortized cost,} and Subtopic 835-30 on the imputation of interest.

Example 29 — Advance Payment and Assessment of Discount Rate

55-240 An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (that is, the performance obligation will be satisfied at a point in time). The contract includes 2 alternative payment options: payment of $5,000 in 2 years when the customer obtains control of the asset or payment of $4,000 when the contract is signed. The customer elects to pay $4,000 when the contract is signed.

55-241 The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

55-242 The interest rate implicit in the transaction is 11.8 percent, which is the interest rate necessary to make the 2 alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 606-10-32-19, the rate that should be used in adjusting the promised consideration is 6 percent, which is the entity's incremental borrowing rate.

ASC 606-10 (continued)

55-243 The following journal entries illustrate how the entity would account for the significant financing component.

a. Recognize a contract liability for the $4,000 payment received at contract inception.

Cash	4,000	
Contract liability		4,000

b. During the 2 years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 606-10-32-20) and accretes the contract liability by recognizing interest on $4,000 at 6 percent for 2 years.

Interest expense	494[a]	
Contract liability		494

[a] $494 = $4,000 contract liability × (6 percent interest per year for 2 years)

c. Recognize revenue for the transfer of the asset.

Contract liability	4,494	
Revenue		4,494

Q&A 6-20 Determining the Appropriate Discount Rate When Accounting for a Significant Financing Component in an Individual Contract

Entity X sells industrial products to customers under contracts for which payment is due 24 months after delivery. Entity X determines that the contract terms give customers a significant benefit of financing the purchase of the industrial products. Accordingly, in accordance with ASC 606-10-32-15, X adjusts the transaction price and corresponding amount of revenue recognized for the sale of the goods to take into account the effect of the time value of money. Entity X does not intend to apply a portfolio approach in determining the effects of this financing benefit.

Question

How might X determine the appropriate discount rate to apply to the payments to be received from its customers?

Answer

Under ASC 606-10-32-19, X should use the discount rate that would be reflected in a separate financing transaction between itself and its customer at contract inception. The way in which X identifies this rate will depend on the type of information to which it has access for individual customers.

In determining this discount rate, X may find it useful to consider the following:

- The normal rate at which X would provide secured or unsecured lending (whichever is appropriate) to this customer (e.g., any interest rate that would be normal for X to offer this customer).
- The normal rate at which other entities would provide secured or unsecured lending (whichever is appropriate) to this customer (e.g., the rate charged to the customer for bank loans). Note, however, that ASC 606-10-32-19 requires a rate specific to a financing transaction between the entity and its customer.

- The cash sales price offered for this product to customers with similar demographic characteristics.
- Any interest rate explicitly stated in the contract with the customer. However, this will not always be an appropriate rate (e.g., when a customer is offered interest-free credit or when a low interest rate is used to incentivize the customer).
- The level of certainty regarding the customer's credit characteristics that X obtains as a result of its due diligence processes (e.g., obtaining credit ratings).
- Historical evidence of any defaults or slow payment by this customer.

Appropriate adjustments should be made to rates associated with any of these factors when they are not directly comparable to those of the transaction being considered.

Q&A 6-21 Determining the Appropriate Discount Rate to Use When Accounting for a Significant Financing Component in a Contract Using a Portfolio Approach

Entity X is a retail business that enters into a large number of similar contracts in which it sells products to individual customers and payment is due 24 months after delivery.

Entity X determines that the contract terms give customers a significant benefit of financing the purchase of the products. Accordingly, under ASC 606-10-32-15, X adjusts the transaction price and corresponding amount of revenue recognized for the sale of the goods to take into account the effect of the time value of money.

Entity X reasonably expects that the financial statement effects of calculating a discount rate that applies to the portfolio of contracts would not differ materially from the discount rates that would apply to individual contracts. Therefore, in accordance with ASC 606-10-10-4, it intends to apply such a portfolio approach. See Q&A 3-2 for guidance on how to decide whether an entity may use a portfolio approach when applying ASC 606.

Question

How might X determine the appropriate discount rate to apply to a portfolio of contracts?

Answer

Under ASC 606-10-32-19, X should use the discount rate that would be reflected in a separate financing transaction between itself and its customers at contract inception.

Factors that may be relevant to determining such a rate are discussed in Q&A 6-20 above. However, in applying a portfolio approach, X will need to consider the demographic characteristics of the customers as a group to estimate the discount rate on a portfolio basis. If the demographic characteristics of customers within this group vary significantly, it may not be appropriate to treat them as a single portfolio and it may be necessary to further subdivide the customer group when making this determination.

6.3.5 Illustrating the Guidance on Significant Financing Components

Q&As 6-22 and 6-23 below provide full illustrations of the significant financing concept in ASC 606 and the relevant guidance and interpretations discussed in Sections 6.3.1 through 6.3.4.

Q&A 6-22 Deferred Consideration: Measuring the Amount of Revenue When a Transaction Includes a Significant Financing Component

An entity has entered into a revenue transaction on deferred payment terms and, upon assessing the requirements in ASC 606-10-32-16 and 32-17, has determined that the transaction includes a significant financing component.

Question

How should the entity measure the amount of revenue when a significant financing component is present?

Answer

When a significant financing component is identified, ASC 606-10-32-15 requires an entity to "adjust the promised amount of consideration for the effects of the time value of money."

ASC 606-10-32-16 states, in part:

> The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price).

However, ASC 606-10-32-19 states, in part:

> To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract.

ASC 606-10-32-19 also notes that "[a]n entity **may** be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer" (emphasis added).

Accordingly, although the objective described in ASC 606-10-32-16 is to determine the "cash selling price," ASC 606-10-32-19 makes clear that such price is required to be consistent with the price that would be determined by using an appropriate discount rate to discount the promised consideration.

Therefore, in practice, the entity may make an initial estimate of the amount of revenue either (1) by determining the appropriate discount rate and using that rate to discount the promised amount of consideration or (2) by estimating the cash selling price directly — but only if the discount rate thereby implied is consistent with a rate that would be reflected in a separate financing transaction between the entity and its customer.

Regardless of the approach it adopts, the entity may need to perform further analysis if the amounts estimated appear unreasonable or inconsistent with other evidence related to the transaction. For example:

- If the entity estimates revenue by discounting the promised consideration, it may be required to perform further analysis if that estimate appears unreasonable and inconsistent with other evidence of the cash selling price. For example, if the amount of revenue estimated appears significantly higher than the normal cash selling price, this may indicate that the discount rate has not been determined on an appropriate basis.
- If the entity estimates revenue by estimating the cash selling price directly, it may be required to perform further analysis if the resulting discount rate appears unreasonable and inconsistent with other evidence of the rate that would be reflected in a separate financing transaction between the entity and its customer. If the rate is clearly significantly lower or higher than would be reflected in a separate financing transaction, it will not be appropriate to measure revenue by reference to the cash selling price; instead, the entity should estimate revenue by discounting the promised consideration at an appropriately estimated discount rate.

The example below illustrates how an entity would (1) estimate revenue by discounting promised consideration and subsequently recognize the associated financing component and (2) determine and subsequently recognize the financing component when revenue is estimated on the basis of the cash selling price.

Example

On January 1, 20X1, Entity B sells an item of equipment for $100,000 under a financing agreement that has no stated interest rate. On the date of sale, B transfers control of the equipment to the customer, and B concludes that the contract meets the criteria in ASC 606-10-25-1, including the collectibility criterion. The first annual installment of $20,000 is due on December 31, 20X1, one year from the date of sale, and each subsequent year for five years. The policy of not charging interest is consistent with normal industry practice. Entity B has separately determined that the transaction includes a significant financing component.

Case A — Discounting on the Basis of Interest Rate

To estimate the transaction price by discounting the future receipts, B uses a "rate that would be reflected in a separate financing transaction between [Entity B] and its customer at contract inception." Entity B determines that the appropriate annual rate is 10 percent. Assume that the receivable arising from the transaction is measured at amortized cost after initial recognition.

Step A — Calculate the Net Present Value of the Stream of Payments

If there is no down payment and there are five annual installments of $20,000 with an interest rate of 10 percent, the net present value of the stream of payments forming the consideration is $75,816.

Therefore, upon transfer of control of the equipment, $75,816 is recognized as revenue from the sale of goods, and the related receivable is recognized.

Example (continued)

Step B — Calculate the Amount of Interest Earned in Each Period

The difference between $100,000 and $75,816 (i.e., $24,184) will be recognized as interest income as it becomes due each year, as calculated below.

	Receivable as of January 1	Interest Income	Payment Received	Receivable as of December 31
	A	B = (A × 10%)	C	A + B – C
20X1	$ 75,816	$ 7,581	$ 20,000	$ 63,397
20X2	63,397	6,340	20,000	49,737
20X3	49,737	4,974	20,000	34,711
20X4	34,711	3,471	20,000	18,182
20X5	18,182	1,818	20,000	—
		$ 24,184	$ 100,000	

Step C — Record Journal Entries

On the date of sale, control of the equipment transfers to the customer and B records the following journal entry:

Accounts receivable	75,816	
Revenue		75,816

To record the first annual payment due one year from the date of purchase:

Cash	20,000	
Accounts receivable		12,419
Interest income		7,581

As of each subsequent year-end, B should record the same journal entry by using the amounts from the table above.

Note that this example does not take into account any impairment assessment that would be required in accordance with ASC 310.

Case B — Discounting to Current Cash Sales Price

If the buyer had paid in full for the equipment at the point of transfer, B estimates that the cash selling price would have been $76,000.

Assume that the receivable arising from the transaction is measured at amortized cost after initial recognition.

Step A — Determine the Discount Rate for the Customer

ASC 606-10-32-19 indicates that a selling entity may be able to determine the discount rate to be used to adjust the transaction price "by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer." Therefore, Entity B determines the interest rate that discounts $100,000 to $76,000 (i.e., the cash selling price) over a five-year period, given no down payment and five annual installments of $20,000. This interest rate is approximately 9.905 percent per annum, which is judged to be consistent with a rate that would be reflected in a separate financing transaction between B and its customer. Upon transfer of the equipment, $76,000 is recognized as revenue from the sale of goods, and the related receivable is recognized.

Example (continued)

Step B — Calculate the Amount of Interest Earned in Each Period

The difference between $100,000 and $76,000 (i.e., $24,000) will be recognized as interest income as it becomes due each year, as calculated below.

	Receivable as of January 1	Interest Income	Payment Received	Receivable as of December 31
	A	B = (A × 9.905%)	C	A + B – C
20X1	$ 76,000	$ 7,528	$ 20,000	$ 63,528
20X2	63,528	6,292	20,000	49,820
20X3	49,820	4,935	20,000	34,755
20X4	34,755	3,443	20,000	18,198
20X5	18,198	1,802	20,000	—
		$ 24,000	$ 100,000	

Step C — Record Journal Entries

On the purchase date, control of the equipment transfers to the customer, and B records the following journal entry:

Accounts receivable	76,000	
Revenue		76,000

Entity B records the following journal entry to reflect the first annual payment due one year from the date of purchase:

Cash	20,000	
Accounts receivable		12,472
Interest income		7,528

As of each subsequent year-end, B should record the same journal entry by using the amounts from the table above.

Note that this example does not take into account any impairment assessment that would be required in accordance with ASC 310.

Q&A 6-23 Advance Payment and Time Value of Money — Example

Entity A, a homebuilder, is selling apartment units in a new building for which construction has not yet commenced. The estimated time to complete construction is 18 months. Entity A has concluded that its performance obligation (i.e., delivery of the apartment) will be satisfied upon completion of construction, which is also when title and possession are passed to the customer. The cash sales price upon completion of construction is $500,000. Customers are offered a discount of $75,000 on the cash sales price if they pay in full in advance; therefore, the price for customers paying in advance is $425,000.

Entity A has concluded after analysis of the contract that the advance payment represents a significant financing component; that is, its customers are providing financing to pay for construction costs. On the basis of interest rates in the market, A has concluded that an annual rate of approximately 10 percent reflects the rate at which A and its customer would have entered into a separate financing transaction. Consequently, A imputes a discount rate of approximately 10 percent to discount the cash sales price (i.e., $500,000) to the “advance” sales price (i.e., $425,000).

When an advance cash payment is received from a customer, A recognizes a contract liability of $425,000. Subsequently, A accrues interest on the liability balance to accrete the balance to $500,000 over the 18-month period until it expects its performance obligation to be satisfied. Entity A capitalizes into inventory the interest in accordance with ASC 835-20. When control of the apartment transfers to the customer, A recognizes $500,000 as revenue.

The following journal entries illustrate how A should account for the significant financing component:

Step 1

Journal Entry: At contract inception		
Cash	425,000	
Contract liability		425,000

Step 2

Journal Entry: Over 18 months from contract inception to transfer of asset		
Inventories	75,000	
Contract liability		75,000

Step 3

Journal Entry: On transfer of control of the asset		
Contract liability	500,000	
Revenue		500,000

6.3.6 Presenting the Effects of Financing

ASC 606-10

32-20 An entity shall present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer. In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

In paragraph BC244 of ASU 2014-09, the FASB and IASB note that the presentation of a significant financing component in the financial statements should not be any different from the presentation that would have resulted if the party receiving the financing in the arrangement had instead obtained financing from a third-party source (e.g., if instead of obtaining the financing from the entity, the customer had obtained financing from the bank and purchased the good or service from the entity at the cash selling price). Accordingly, as a result of the presentation requirements in ASC 606-10-32-20, economically similar transactions are reflected similarly in the financial statements.

Example 26 in ASC 606, which is reproduced below, illustrates (1) the presentation of the effects of financing in a contract with a customer that also contains a right of return and (2) the concept in the second sentence of ASC 606-10-32-20 that a significant financing component affects profit and loss at the time the contract asset (receivable) or liability is recognized rather than at contract inception.

ASC 606-10

Example 26 — Significant Financing Component and Right of Return

55-227 An entity sells a product to a customer for $121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new, and the entity has no relevant historical evidence of product returns or other available market evidence.

55-228 The cash selling price of the product is $100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is $80.

55-229 The entity does not recognize revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, revenue is recognized after three months when the right of return lapses.

55-230 The contract includes a significant financing component, in accordance with paragraphs 606-10-32-15 through 32-17. This is evident from the difference between the amount of promised consideration of $121 and the cash selling price of $100 at the date that the goods are transferred to the customer.

ASC 606-10 (continued)

55-231 The contract includes an implicit interest rate of 10 percent (that is, the interest rate that over 24 months discounts the promised consideration of $121 to the cash selling price of $100). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs 606-10-55-22 through 55-29:

a. When the product is transferred to the customer, in accordance with paragraph 606-10-55-23.

Asset for right to recover product to be returned	80[(a)]	
Inventory		80

(a) This Example does not consider expected costs to recover the asset.

b. During the three-month right of return period, no interest is recognized in accordance with paragraph 606-10-32-20 because no contract asset or receivable has been recognized.

c. When the right of return lapses (the product is not returned).

Receivable	100[(b)]	
Revenue		100
Cost of sales	80	
Asset for product to be returned		80

(b) The receivable recognized would be measured in accordance with Topic 310 on receivables. This Example does not consider the impairment accounting for the receivable. {The receivable recognized would be measured in accordance with Subtopic 326-20. This Example does not consider the credit loss accounting for the receivable.}

55-232 Until the entity receives the cash payment from the customer, interest income would be recognized consistently with the subsequent measurement guidance in Subtopic 835-30 on imputation of interest. The entity would accrete the receivable up to $121 from the time the right of return lapses until customer payment.

6.3.7 Reassessment of Significant Financing Component

ASC 606-10-32-19 (reproduced in Section 6.3.4 above) states that "[a]fter contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk)." An entity is thus not required to update the discount rate used to measure a significant financing component as it would otherwise be required to reassess and remeasure, for example, variable consideration (see Section 6.2.6). Paragraph BC243 of ASU 2014-09 indicates that as much as for any other reason, the FASB and IASB deemed reassessment of the discount rate inappropriate because of the impracticality of updating it in each subsequent reporting period for changes in facts and circumstances.

Thinking It Through — Implications of Not Reassessing the Discount Rate

The boards' decision with respect to reassessing the discount rate reflects a conscious and substantial form of relief to preparers. In a manner consistent with the boards' decision to establish stand-alone selling prices in step 4 as of contract inception (see Chapter 7), the boards decided that the determination of the discount rate and stand-alone selling prices should not be adjusted even if facts and circumstances change over the course of the entity's performance under the contract (e.g., when, over the term of a 5- or 10-year contract, it is likely that the discount rate or the stand-alone selling prices of individual goods or services will economically shift). This relief may pose challenges when the timing of delivery of the goods and services shifts after contract inception. The complexity is exacerbated when variable consideration is reassessed and the reassessment results in an updated estimate that needs to be reallocated to individual performance obligations. Unlike the static discount rate and stand-alone selling price estimates, estimates of variable consideration need to be reassessed and updated as uncertainties become known. In addition, the timing of delivery of goods and services is likely to change from estimates made at contract inception and directly contributes to when revenue and the impact of financing are recognized. As a result, when a contract includes multiple performance obligations that are expected to be satisfied over a longer period and also contains a significant financing component and variable consideration, the recognition of revenue for those separate performance obligations may become complex and challenging.

6.4 Noncash Consideration

ASC 606-10

32-21 To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception (that is, the date at which the criteria in paragraph 606-10-25-1 are met).

32-22 If an entity cannot reasonably estimate the fair value of the noncash consideration, the entity shall measure the consideration indirectly by reference to the standalone selling price of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

32-23 The fair value of the noncash consideration may vary after contract inception because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer). Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price. If the fair value of the noncash consideration promised by a customer varies for reasons other than the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity shall apply the guidance in paragraphs 606-10-32-5 through 32-14 on variable consideration only to the variability resulting from reasons other than the form of the consideration.

32-24 If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.

When providing goods or services, an entity may receive noncash consideration from its customers (e.g., goods, services, shares of stock). Step 3 requires entities to include the fair value of the noncash consideration in the transaction price. Paragraph BC248 of ASU 2014-09 states the FASB's and IASB's rationale for this requirement: "When an entity receives cash from a customer in exchange for a good or service, the transaction price and, therefore, the amount of revenue should be the amount of cash received (that is, the value of the inbound asset). To be consistent with that approach, the Boards decided that an entity should measure noncash consideration at fair value." Further, in issuing ASU 2014-09 and IFRS 15, the boards included guidance stating that changes in the fair value of noncash consideration for reasons other than its form would be subject to the variable consideration constraint in ASC 606-10-32-11 through 32-13 (paragraphs 56 through 58 of IFRS 15).

During the FASB's outreach on issues related to the implementation of ASU 2014-09, stakeholders indicated that they were unclear about the measurement date in the determination of the fair value of noncash consideration received in a contract with a customer. Further, they questioned the applicability of the variable consideration constraint when changes in the fair value of the noncash consideration are due both to (1) its form (e.g., stock price changes attributable to market conditions) and (2) reasons other than its form (e.g., additional shares of stock that may become due on the basis of a contingent event).

In response, the FASB issued[2] ASU 2016-12, which defines the measurement date for noncash consideration as the "contract inception" date and clarifies that this is the date on which the criteria in step 1 are met (i.e., the criteria in ASC 606-10-25-1, as discussed in Chapter 4). In addition, the transaction price does not include any changes in the fair value of the noncash consideration after the contract inception date that are due to its form. Further, ASU 2016-12 states that if changes in noncash consideration are due both to its form and to reasons other than its form, only variability resulting from changes in fair value that are due to reasons other than the consideration's form is included in the transaction price as variable consideration (and thus also subject to the variable consideration constraint).

Lastly, some stakeholders asked the FASB to clarify how the fair value of noncash consideration should be measured on the contract inception date. As noted in paragraph BC39 of ASU 2016-12, the FASB elected not to clarify the measurement process because it believes that "the concept of fair value exists in other parts of [ASC] 606," and an entity will need to use judgment in determining fair value.

The Codification example and Q&A below illustrate the application of the new revenue guidance on noncash consideration in two different contractual scenarios.

ASC 606-10

Example 31 — Entitlement to Noncash Consideration

55-248 An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on January 1, 20X1, and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

55-249 In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

55-250 To determine the transaction price (and the amount of revenue to be recognized), the entity measures the estimated fair value of 5,200 shares at contract inception (that is, on January 1, 20X1). The entity measures its progress toward complete satisfaction of the performance obligation and recognizes revenue as each week of service is complete. The entity does not reflect any changes in the fair value of the 5,200 shares after contract inception in the transaction price. However, the entity assesses any related contract asset or receivable for impairment. Upon receipt of the noncash consideration, the entity would apply the guidance related to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception should be recognized.

[2] ASU 2016-12 and the FASB's updates to the guidance on noncash consideration reflect a difference between ASC 606 and IFRS 15. The IASB decided not to make the changes in ASU 2016-12 to IFRS 15. As a result, IFRS 15 does not require the measurement of noncash consideration as of the inception date and does not clarify whether the guidance on variable consideration applies only to variability resulting from reasons other than form. See Appendix A for a summary of differences between ASC 606 and IFRS 15.

Q&A 6-24 Noncash Consideration in the Form of Publicly Traded Common Stock — Example

As part of a revenue contract with a customer for the delivery of goods, an entity is entitled to receive 500 shares of its customer's common stock when all of the goods are provided to the customer. In addition, if the entity delivers all goods within 90 days, it will receive an additional 100 shares of the customer's common stock. The changes in the fair value of the noncash consideration may vary between the contract inception date and the delivery of goods as a result of (1) the form of the common stock (i.e., because of changes in the market value) and (2) reasons other than its form (i.e., the quantity of shares that the entity will receive may vary because delivery occurs in 90 days).

ASU 2016-12 clarifies that the transaction price would include as variable consideration (subject to the variable consideration constraint) only changes in fair value that are due to reasons other than the consideration's form, which, in this example, is the quantity of shares to be received by the entity. Consequently, in this example, increases or decreases in the market value of the common stock would not be recorded as adjustments to the transaction price (i.e., revenue).

Driving Discussion — Embedded Derivatives in Noncash Consideration

The example in Q&A 6-24 above illustrates variability in noncash consideration that is due to both (1) its form (i.e., changes in the market price of the common stock) and (2) drivers other than its form (i.e., the occurrence or nonoccurrence of an event). This example makes it easier to see how the measurement guidance in ASU 2016-12 after contract inception would come into play. In short, variable consideration in item (2) would be subsequently reassessed and remeasured, but variable consideration in item (1) would not be. In paragraph BC39 of ASU 2016-12, the FASB acknowledges that for item (1), the entity would thus be required to assess whether there is an embedded derivative that should also be bifurcated and measured at fair value in accordance with ASC 815-15. The FASB reasons in paragraph BC39 that contracts with noncash consideration are most commonly for payment in the form of shares of a nonpublic entity. Such shares would most likely not meet all of the criteria in ASC 815-15 to be bifurcated as an embedded derivative because they are not readily convertible to cash. However, stakeholders in other industries with nonmonetary exchanges (e.g., certain commodity transactions) have raised this issue as a new concern as a result of ASU 2016-12, and they continue to monitor implementation and interpretive efforts related to the noncash consideration guidance issued in May 2016.

Driving Discussion — Barter Exchanges in the Media Industry

Arrangements between media producers and broadcasters often include a requirement that the broadcaster air certain advertising spots for the media producer during the broadcast of the media producer's content. For example, assume that a media producer enters into an agreement to license one season of a syndicated television sitcom (10 episodes, each with 22 minutes of content) to a broadcast network in exchange for $5 million in cash. The arrangement stipulates that each time one of the sitcom episodes airs in a 30-minute time slot on the network, the media producer is allowed to sell, and have aired, advertising spots (i.e., commercials) for 4 of the 8 available minutes of airtime while the broadcast network will provide the advertising spots for the remaining 4 minutes.

Industry stakeholders have considered whether the agreement to allow the media producer to sell advertising spots that will air during the broadcast of the syndicated sitcom represents noncash consideration in exchange for licensing the syndicated sitcom to the broadcast network. This issue was ultimately brought to the attention of the FASB and SEC staffs by industry stakeholders and public accounting firms.

The FASB staff generally preferred a view that the future advertising spots provided by the broadcast network to the media producer are not a form of noncash consideration that the media entity receives in exchange for a license to the media content. The FASB staff indicated that they gave particular weight to an understanding that the value of the future advertising spots is inextricably linked to the value of the licensed content; the more valuable or popular the syndicated sitcom is, the more valuable the future advertising spots are. Accordingly, the FASB staff noted that in these particular unique circumstances, the arrangements could be viewed as either of the following:

- Two arrangements: one for the license of IP (i.e., the syndicated sitcom) and another for the sale of future advertising spots.
- A profit-sharing arrangement that includes fixed consideration and variable consideration in the form of a sales- or usage-based royalty.

The FASB staff noted that either approach would result in similar reporting outcomes. That is, revenue would be recognized (1) as fixed consideration upon the transfer of the license of IP and (2) as variable consideration as the media producer sells future advertising spots and such spots are aired.

The FASB staff also noted that it could not object to a view that the future advertising spots provided by the broadcast network to the media producer represent noncash consideration in accordance with ASC 606-10-32-21. However, the FASB staff noted the difficulties associated with applying the noncash consideration measurement guidance in ASC 606-10-32-21 through 32-24 to advertising space if such was concluded to be noncash consideration.

The SEC staff noted that preparers should provide sufficient detailed disclosures to enable financial statement users to understand the entity's evaluation of the nature, substance, and economics of these arrangements.

6.5 Consideration Payable to a Customer

If an entity makes (or promises to make) a cash payment to a customer in (or related to) a contract with that customer to subsequently receive the return of that cash through purchases of its goods or services by the customer, the economics of the transaction do not justify the entity's recognition of revenue for the amounts it paid up front. As a result, current revenue guidance issued by the EITF generally precludes the "grossing up" of revenue for the amounts paid to the customer. This ensures that payments made to a customer are appropriately reflected as a reduction of the revenue such that revenue is presented on a "net basis" to more appropriately reflect the economics of the arrangement.

In a manner consistent with the EITF's views, the FASB included similar guidance in ASC 606:

ASC 606-10

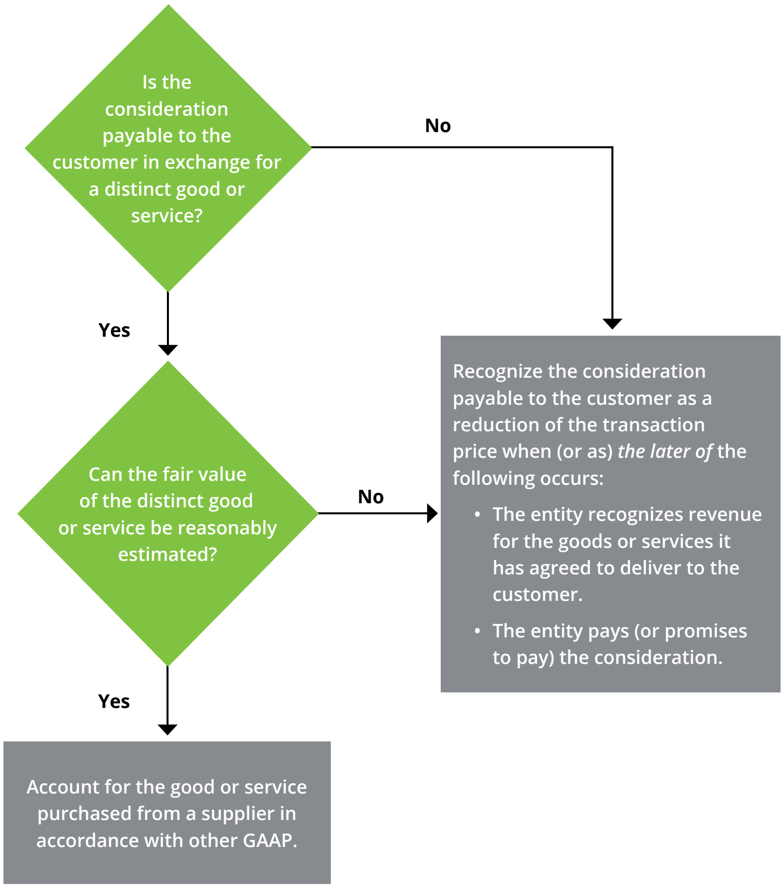
32-25 Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

32-26 If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

32-27 Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

a. The entity recognizes revenue for the transfer of the related goods or services to the customer.
b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

The FASB and IASB acknowledge in paragraph BC255 of ASU 2014-09 that consideration in a contract with a customer may be payable by an entity to its customer in various forms (e.g., a cash discount, or a payment in exchange for good or services). Accordingly, an entity should consider the following thought process in determining how to account for its consideration payable in a contract to its customer:



The Q&As and Codification example in Sections 6.5.1 through 6.5.3 below reflect the application of the decision tree above as well as interpretations of the guidance that have resulted from a number of discussions and considerations identified by various stakeholders in the ASC 606 implementation processes, including the TRG.

6.5.1 Scope of the Guidance on Consideration Payable to a Customer

Q&A 6-25 Identifying Customers Within the Scope of the Requirements Related to "Consideration Payable to a Customer"

ASC 606-10-32-25 through 32-27 establish requirements related to "consideration payable to a customer." ASC 606-10-32-25 states that those requirements apply to (1) an entity's customer (defined in the ASC 606 glossary as a "party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration") and (2) other parties that purchase the entity's goods or services from the customer (commonly referred to as other parties "in the distribution chain," such as a reseller).

Question

Do the requirements related to consideration payable to a customer apply only to parties in the distribution chain, or should they be applied more broadly?

Answer

The requirements should be applied more broadly to include parties outside the distribution chain depending on the facts and circumstances. ASC 606-10-32-25 is clear that the requirements of ASC 606-10-32-25 through 32-27 apply to parties in the distribution chain. In addition, depending on the circumstances, an entity might identify a customer beyond the distribution chain. In some instances, an agent that arranges for a supplier (the principal) to supply goods to a third party (the end customer) might regard both the principal and the end customer as its customers.

For example, if the agent has an agreement with the principal to provide consideration to the end customer (e.g., to incentivize the end customer to purchase the principal's goods or services), the entity acting as an agent might view both the principal and the end customer as its customers. In such a case, the entity acting as an agent should evaluate the consideration payable to the end customer to determine whether that consideration is consideration payable to a customer (i.e., a reduction of revenue rather than an amount recognized as an expense) in accordance with ASC 606-10-32-25 through 32-27.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 6-26 Identifying Payments Within the Scope of the Requirements Related to "Consideration Payable to a Customer"

ASC 606-10-32-25 through 32-27 establish requirements related to "consideration payable to a customer." Consideration payable to a customer includes cash amounts[3] that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (typically resulting in the recognition of an asset or expense).

Question

Do the requirements related to consideration payable to a customer apply to all payments by an entity to its customers?

Answer

An entity should assess the following payments to customers under ASC 606-10-32-25 to determine whether they are in exchange for a distinct good or service:

- Payments to customers that result from a contractual obligation (either implicitly or explicitly).
- Payments to customers that can be economically linked to revenue contracts with those customers.

[3] ASC 606-10-32-25 states that consideration payable to a customer "also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer)."

While an entity is not required to separately assess and document each payment made to a customer, an entity should not disregard payments that extend beyond the context of a specific revenue contract with a customer. Rather, an entity should use reasonable judgment when determining how broadly to apply the guidance on consideration payable to a customer to determine whether the consideration provided to the customer is in exchange for a distinct good or service (and is therefore an asset or expense) or is not in exchange for a distinct good or service (and is therefore a reduction of revenue).

For example, an entity may purchase goods from a customer in a separate transaction for an amount that significantly exceeds the fair value of those goods. In such cases, the entity should determine whether the excess price paid is attributable to another transaction (i.e., a revenue contract with the customer).

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

6.5.2 Applying the Guidance on Consideration Payable to a Customer

ASC 606-10

Example 32 — Consideration Payable to a Customer

55-252 An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least $15 million of products during the year. The contract also requires the entity to make a nonrefundable payment of $1.5 million to the customer at the inception of the contract. The $1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

55-253 The entity considers the guidance in paragraphs 606-10-32-25 through 32-27 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 606-10-32-25, the $1.5 million payment is a reduction of the transaction price.

55-254 The entity applies the guidance in paragraph 606-10-32-27 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognizes revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 percent ($1.5 million ÷ $15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognizes revenue of $1.8 million ($2.0 million invoiced amount – $0.2 million of consideration payable to the customer).

Q&A 6-27 Consideration Payable to a Customer — Meaning of "Distinct" Goods or Services

As required under ASC 606-10-32-3, when an entity is determining the transaction price, it should consider the effect of consideration payable to a customer, which includes the following items described in ASC 606-10-32-25:

- "[C]ash amounts that [the] entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer)."
- "[C]redit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer)."

Consideration payable to a customer should generally be accounted for as a reduction of the transaction price (and, therefore, of revenue). However, ASC 606-10-32-26 provides that if the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity, the entity should "account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers."

Question

How should an entity determine whether the consideration payable to a customer is related to "distinct" goods or services?

Answer

ASC 606-10-32-25 refers to ASC 606-10-25-18 through 25-22 for guidance on the identification of distinct goods or services. Specifically, in the context of consideration payable to a customer, application of ASC 606-10-25-19 would lead to a determination that goods or services are distinct if both of the following criteria are met:

- The entity can benefit from the good or service supplied by the customer (either on its own or together with other resources that are readily available to the entity).
- The customer's promise to transfer the good or service to the entity is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract, and the benefit to be received by the entity is separable from the sale of goods by the entity to the customer).

See Chapter 5 for further discussion of identifying distinct goods or services in a contract with a customer.

Paragraph BC256 of ASU 2014-09 explains that the principle for assessing whether a good or service is distinct is similar to the concept of an "identifiable benefit" previously applied under U.S. GAAP. As stated in paragraph BC256, an identifiable benefit "was described as a good or service that is 'sufficiently separable from the [customer's] purchase of the vendor's products such that the vendor could have entered into an exchange transaction with a party other than a purchaser of its products or services in order to receive that benefit.' "

Transactions that involve payments by an entity to a customer frequently arise in the retail industry. One transaction of this nature is illustrated in Example 32 of the new revenue standard (ASC 606-10-55-252 through 55-254 above), in which an entity makes a payment to a customer to compensate it for changes it needs to make to its shelving to accommodate the entity's products.

Note that when an entity concludes that the consideration payable to a customer is for distinct goods or services that the entity receives, the entity is also required to assess whether it can reasonably estimate the fair value of those distinct goods or services (see Q&A 6-28).

The examples below discuss common transactions in the retail industry and illustrate how an entity should determine whether the goods or services supplied by a customer are distinct.

Example 1

Slotting Fees

Entity X contracts to sell products to Entity Y, a retailer. As part of the contract, Y promises to display the products in a prime location within its store to encourage sales of those products to the end customer (payments for such services are commonly referred to as "slotting fees").

To determine the appropriate accounting, X considers whether the services provided by Y are "distinct." Entity X concludes that its only substantive benefit from those services will be through additional sales in Y's store and that it would not enter into an exchange transaction with a party other than a purchaser of its products to receive that benefit (i.e., it would not pay for the services if Y were not also purchasing goods from X). Consequently, although X believes that it receives benefit from the services provided by Y, it concludes that the benefit received is highly interrelated with its own sales of goods to Y. Therefore, it concludes that the services provided by Y are not sufficiently separable from Y's purchases of X's products to be regarded as distinct.

Accordingly, any payments made, or discounts provided, to Y in exchange for such slotting services should be accounted for as a reduction of the transaction price recognized by X in accordance with ASC 606-10-32-25 and ASC 606-10-32-27 (see Q&A 6-28).

Example 2

Consideration Payable to a Customer in Exchange for Advertising in an In-Store Circular

Entity F contracts to sell products to Entity G, a retailer. As part of the contract, G agrees to include F's products in G's weekly in-store advertising circular.

To determine the appropriate accounting, F considers whether the in-store advertising services provided by G are "distinct." Entity F concludes that its only substantive benefit from those services will be through additional sales in G's store and that it would not pay for the services if G were not also purchasing goods from F. Consequently, although F believes that it receives benefit from the services supplied by G (thus meeting the criterion in ASC 606-10-25-19(a)), it concludes that the benefit received is highly interrelated with its own sale of goods to F; the service received is not distinct in the context of the contract (thus failing the criterion in ASC 606-10-25-19(b)).

Accordingly, any payments made, or discounts provided, to G in exchange for the inclusion of F's products in G's weekly in-store advertising circular would be considered a reduction of the transaction price recognized by F in accordance with ASC 606-10-32-25 and ASC 606-10-32-27 (see Q&A 6-28).

Example 3

Consideration Payable to a Customer in Exchange for Broadly Distributed Advertising

Entity J contracts to sell a particular product to Entity K, a retailer, and also sells that product through other retailers and directly to the public via its Web site. As part of the contract, K agrees to advertise the sale of J's product in a national newspaper and on national television and radio in exchange for cash consideration.

To determine the appropriate accounting, J considers whether the advertising services provided by K are "distinct." Entity J concludes that (1) it will benefit from the advertising undertaken by K through increased sales in all retail stores that sell the product (not just in K's store) and via its Web site and (2) it would enter into an exchange transaction with a party other than a purchaser of its product to receive that benefit (e.g., it could purchase advertising services directly from the regional media outlets). Entity J concludes that the services provided by K are sufficiently separable from K's purchase of J's product and are therefore distinct.

Example 3 (continued)

Accordingly, J should assess whether it can reasonably estimate the fair value of the advertising services that it will receive (which may not correspond to any amount specified in the contract for those services). If that fair value can be reasonably estimated, J should record the lesser of the fair value of those services or the consideration paid to the customer as an expense when the advertising services are received.

If the fair value cannot be reasonably estimated, any consideration payable by J to K with respect to services should be accounted for as a reduction in the transaction price for the sale of goods to K. In addition, any amount of consideration paid to K that exceeds the fair value of the advertising services received should be accounted for as a reduction of the transaction price for the sale of goods to K.

Driving Discussion — Slotting Fees

Another example of a situation in which stakeholders question how to determine whether a contract provides a distinct good or service to a customer is within the retail industry. It is common for a wholesaler to pay a retailer (the "customer") (1) fees to have the products allocated to attractive or advantageous spaces in the retailer's premises for a defined period ("slotting fees") and (2) fees to be included in the retailer's list of authorized suppliers ("listing fees"). ASC 606-10-32-25 requires an entity to account for consideration paid to a customer as a reduction of the transaction price "unless the payment to the customer is in exchange for a distinct good or service." Given the example and guidance, stakeholders have asked whether the wholesaler receives a distinct good or service from the retailer in return for the payment of slotting or listing fees.

Our view is that slotting and listing fees cannot be separated from the sale of the products to the retailer (since the fees are not paid when no products are sold) and thus have no value to the wholesaler unless these payments are linked to the products sold. Therefore, these slotting and listing fees are not capable of being distinct.

Q&A 6-28 Determining the Transaction Price — Consideration of Goods or Services Supplied to the Entity by the Customer

When an entity enters into an agreement to sell products to a customer, the transaction with the customer may also involve the customer's supplying goods or services to the entity. The contract may be structured in a manner such that the consideration payable by the entity to the customer for those goods or services is separately identified. Alternatively, the contract may be structured in a manner such that it includes a single amount payable by the customer to the entity that reflects the net of the value of the goods or services provided by the entity to the customer and by the customer to the entity.

Question

When a transaction involves the customer's supplying goods or services to the entity, should the entity account for the "net" consideration as revenue, or should the entity account for those goods or services separately (and, accordingly, increase the transaction price for the goods or services provided to the customer)?

Answer

It depends. The goods or services supplied by the customer should be accounted for separately if both of the following conditions are met:

- Those goods or services are "distinct" (see Q&A 6-27).
- The entity can reasonably estimate the fair value of the goods or services that it will receive (which may not correspond to any amount specified in the contract for those goods or services).

If both of these conditions are met, the fair value of the goods or services received from the customer should be accounted for in the same way the entity accounts for other purchases from suppliers (e.g., as an expense or asset). If any consideration payable to the customer with respect to those goods or services exceeds their fair value, the excess should be accounted for as a reduction of the transaction price.

If either or both of these conditions are not met, any consideration payable to the customer with respect to those goods or services should be accounted for as a reduction of the transaction price.

The examples below illustrate the application of this guidance.

Example 1

An entity sells goods to a customer for $10,000 and, as part of the same arrangement, pays that customer $1,000 to provide a service. If the service is determined to be distinct and its fair value can be reasonably estimated (as being, for example, $600), a portion of the contractually stated amount will be recognized as a reduction of the transaction price for the sale of goods to $9,600 ($10,000 minus the $400 payment made to the customer in excess of the fair value of the service received).

Example 2

An entity sells goods to a customer for $10,000 and, as part of the same arrangement, pays that customer $1,000 to provide a service. If the service is not determined to be distinct or its fair value cannot be reasonably estimated, the transaction price for the sale of goods will be reduced to $9,000 ($10,000 minus the full amount payable to the customer).

The requirements above apply irrespective of whether the consideration related to the goods or services supplied by the customer is separately identified in the contract.

6.5.3 Differentiating Between the Guidance on Warranties and the Guidance on Consideration Payable to a Customer

Q&A 6-29 Accounting for a Refund of Purchase Price Following Customer's Return of a Defective Item

ASC 606-10-55-30 through 55-35 provide guidance on the accounting for warranties under which an entity promises to repair or replace defective items, requiring that the warranty obligation be accounted for either as a separate performance obligation (for "service-type" warranties) or in accordance with the guidance on product warranties in ASC 460-10 on guarantees (for "assurance-type" warranties). The warranties guidance is discussed in Section 5.5.

Entities will sometimes provide a customer with a full or partial refund with respect to a defective item. This might be the only option offered to the customer (i.e., the entity does not offer to repair or replace defective items); alternatively, the customer may be entitled to choose between receiving a refund and having the defective item repaired or replaced. A right to receive such a refund might sometimes be described as a "warranty."

Question

Should the guidance on accounting for warranties in ASC 606-10-55-30 through 55-35 be applied to an obligation to provide a full or partial refund of consideration received for defective products?

Answer

No. When amounts are expected to be refunded to a customer for a defective product, a refund liability should be recognized in accordance with ASC 606-10-32-10. The amount expected to be refunded is consideration payable to a customer and therefore reduces revenue in accordance with ASC 606-10-32-25 through 32-27. Because the consideration payable to the customer includes a variable amount, the entity would also need to estimate the transaction price in accordance with ASC 606-10-32-5 through 32-13.

This accounting appropriately reflects that when a full or partial refund is offered, the product delivered to the customer and the consideration payable for that product are both different from what was originally agreed. If no refund is due (i.e., there is no warranty claim), the entity receives full payment for a product that meets agreed-upon specifications, whereas in the case of a full refund, the entity has not delivered a functioning product and has received no payment. A partial refund reflects that the entity has accepted a lower price for an imperfect product.

In contrast, in the case of an assurance-type warranty, neither what is delivered to the customer (a product meeting agreed-upon specifications) nor the price eventually paid by the customer varies. Instead, the cost to the entity of delivery varies, and this variability is appropriately reflected in the warranty costs recognized in accordance with ASC 460-10 (or in the costs of fulfilling the performance obligation in a service-type warranty).

When an entity offers customers a choice between receiving a refund and accepting repair or replacement of defective items, it will be necessary to estimate the extent to which customers will choose each option and then account for each obligation accordingly.

An entity will be required to use judgment to determine the appropriate treatment of any additional amount paid to a customer over and above the amount originally paid by the customer for the product.

6.6 Sales Taxes and Similar Taxes Collected From Customers

ASC 606-10

32-2A An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

Stakeholders have questioned whether sales taxes and similar taxes ("sales taxes") should be excluded from the transaction price when such taxes are collected on behalf of tax authorities.

Further, the new revenue standard's guidance on assessing whether an entity is a principal or an agent in a transaction is relevant to the assessment of whether sales taxes should be presented on a gross or net basis within revenue (see Chapter 10 for further discussion of the assessment of whether an entity is a principal or an agent). The analysis is further complicated by the sales tax in each tax jurisdiction (which would include all taxation levels in both domestic and foreign governmental jurisdictions), especially for entities that operate in a significant number of jurisdictions.

The FASB decided to provide in ASU 2016-12 a practical expedient (codified in ASC 606-10-32-2A) that permits entities to exclude from the transaction price all sales taxes that are assessed by a governmental authority and that are "imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes)." However, such an accounting policy election does not apply to taxes assessed on "an entity's total gross receipts or imposed during the inventory procurement process." An entity that elects to exclude sales taxes is required to provide the accounting policy disclosures in ASC 235-10-50-1 through 50-6.

The guidance aligns the scope of sales taxes in the new revenue standard with that in ASC 605-45-15-2(e) under current revenue guidance. Further, an entity that does not elect to present all sales taxes on a net basis would be required to assess, for every tax jurisdiction, whether it is a principal or an agent in the sales tax transaction and would present sales taxes on a gross basis if it is a principal in the jurisdiction and on a net basis if it is an agent.

Chapter 7 — Step 4: Allocate the Transaction Price to the Performance Obligations

In step 4 of the new revenue standard, an entity allocates the transaction price to each of the identified performance obligations. For a contract containing more than one performance obligation, the allocation is generally performed on the basis of the relative stand-alone selling price of each distinct good or service. However, as discussed below, there are exceptions that allow an entity to allocate a disproportionate amount of the transaction price to a specific performance obligation. For example, an entity may allocate a discount to a single performance obligation rather than proportionately to all performance obligations if certain factors indicate that the discount is related to a specific performance obligation.

ASC 606-10

32-28 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

7.1 Stand-Alone Selling Price

ASC 606-10

32-29 To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

32-30 Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.

The principle of allocating the transaction price to each performance obligation is that consideration should be allocated on the basis of the relative stand-alone selling price of each distinct good or service in the contract. The result of allocating consideration on this basis should be consistent with the overall core principle of the new revenue standard (i.e., to recognize revenue in an amount that depicts the consideration to which the entity expects to be entitled in exchange for the promised goods or services).

ASC 606-10-32-29 requires an entity to allocate the transaction price to each performance obligation on a relative stand-alone selling price basis. In determining the allocation, an entity is required to maximize the use of observable inputs. When the stand-alone selling price of a good or service is not directly observable, an entity is required to estimate the stand-alone selling price. The example below, which is reproduced from ASC 606, illustrates how to apply the standard's allocation method.

ASC 606-10

Example 33 — Allocation Methodology

55-256 An entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately, and, therefore the standalone selling price is directly observable. The standalone selling prices of Products B and C are not directly observable.

55-257 Because the standalone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the standalone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximizes the use of observable inputs (in accordance with paragraph 606-10-32-33). The entity estimates the standalone selling prices as follows:

Product	Standalone Selling Price	Method
Product A	$ 50	Directly observable (see paragraph 606-10-32-32)
Product B	25	Adjusted market assessment approach (see paragraph 606-10-32-34(a))
Product C	75	Expected cost plus a margin approach (see paragraph 606-10-32-34(b))
Total	$ 150	

55-258 The customer receives a discount for purchasing the bundle of goods because the sum of the standalone selling prices ($150) exceeds the promised consideration ($100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs (in accordance with paragraph 606-10-32-37) and concludes that it does not. Consequently, in accordance with paragraphs 606-10-32-31 and 606-10-32-36, the discount is allocated proportionately across Products A, B, and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Standalone Selling Price	
Product A	$ 33	($50 ÷ $150 × $100)
Product B	17	($25 ÷ $150 × $100)
Product C	50	($75 ÷ $150 × $100)
Total	$ 100	

7.2 Determine the Stand-Alone Selling Price

ASC 606-10

32-31 To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.

The stand-alone selling price may be, but is not presumed to be, the contract price. The best evidence of the stand-alone selling price is an observable price for selling the same good or service separately to another customer. If a good or service is not sold separately, an entity must estimate the stand-alone selling price by using an approach that maximizes the use of observable inputs. Acceptable estimation methods include, but are not limited to, (1) the adjusted market assessment approach, (2) the expected cost plus margin approach, and (3) the residual approach (when the stand-alone selling price is not directly observable and is either highly variable or uncertain).

7.2.1 Observable Stand-Alone Selling Prices

ASC 606-10

32-32 The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

Changing Lanes — Elimination of Requirement to Evaluate a Selling Price Hierarchy

The new revenue standard does not require an entity to evaluate a selling price hierarchy as currently required under ASC 605-25. That is, an entity does not need to first conclude that it does not have VSOE of fair value or third-party evidence of fair value for an element before it develops its best estimated selling price. However, the new revenue standard does state that the best evidence of a stand-alone selling price is the observable price when the good or service is sold on a stand-alone basis to similar customers and in similar circumstances (i.e., there is an observable stand-alone selling price). The analysis that would be used to determine an observable stand-alone selling price could be similar to an analysis that would support VSOE of fair value under current U.S. GAAP when VSOE is supported by consistent nominal pricing of stand-alone sales (see Q&A 7-1). In a manner similar to current practice, an entity will need to estimate the stand-alone selling price if an observable stand-alone selling price does not exist.

7.2.2 Estimating Stand-Alone Selling Prices

ASC 606-10

32-33 If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.

ASC 606-10 (continued)

32-34 Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

a. Adjusted market assessment approach — An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
b. Expected cost plus a margin approach — An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
c. Residual approach — An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:
   1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
   2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

32-35 A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

Although ASC 606 does not prescribe a specific approach for estimating stand-alone selling prices that are not directly observable, entities are required to use the approach that maximizes the use of observable inputs and faithfully depicts the selling price of the promised goods or services if the entity sold those goods or services separately to a similar customer in similar circumstances. The selected method should be used consistently to estimate the stand-alone selling price of goods and services that have similar characteristics.

Changing Lanes — Residual Method Under Current U.S. GAAP Versus Residual Approach Under ASC 606

The new revenue standard includes the residual approach as a method that can be used to determine the stand-alone selling price of a distinct good or service. Under current U.S. GAAP, the term "residual method" is used in the guidance on determining the amount of revenue to be recognized for delivered elements in certain software arrangements. Although this method is similar to the residual approach under ASC 606, it is applied differently. Whereas the residual approach under the new revenue standard is used to determine the stand-alone selling price of a performance obligation when one of the criteria in ASC 606-10-32-34(c) is met, the residual method under current U.S. GAAP is used to determine the amount of revenue to recognize for delivered elements in certain software arrangements that are subject to the guidance in ASC 985-605 (formerly SOP 97-2). Since a performance obligation, by definition, has value on a stand-alone basis, the stand-alone selling price of a performance obligation cannot be zero.

Consequently, it is inappropriate for an entity to use the residual approach under the new revenue standard if applying that approach would result in a stand-alone selling price of zero for the performance obligation. However, under current U.S. GAAP, if the fair value (as indicated by VSOE) of the undelivered items in a multiple-element software arrangement is greater than the fixed or determinable consideration in the contract, applying the residual method could result in no consideration being recognized for the delivered items regardless of whether those items could be accounted for as a separate unit of account. This nuance is discussed further in paragraph BC273 of ASU 2014-09.

Another difference between current U.S. GAAP and the new revenue standard is the conditions that need to exist to support the use of the residual method (approach). Under current U.S. GAAP, the residual method should be used whenever there is VSOE of fair value for all undelivered elements in a multiple-element software arrangement. That is, no additional criteria need to be met for an entity to use the residual method. However, under the new revenue standard, the criteria in ASC 606-10-32-34(c) need to be met for the residual approach to be used. That is, an entity must demonstrate that (1) there are observable stand-alone selling prices for one or more of the performance obligations and (2) one of the two criteria in ASC 606-10-32-34(c)(1) and (2) is met. Further, even when the criteria for using the residual approach are met, the resulting allocation would need to be consistent with the overall allocation objective. That is, if the residual approach results in either a stand-alone selling price that is not within a range of reasonable stand-alone selling prices or an outcome that is not aligned with the entity's observable evidence, use of the residual approach would not be appropriate even if the criteria in ASC 606-10-32-34(c) are met. An entity should use all available information to determine the stand-alone selling price, which may include an assessment of market conditions adjusted for entity-specific factors. When such an analysis results in a highly variable or broad range and the residual approach is used to estimate the stand-alone selling price, this observable information should still be used to support the reasonableness of the resulting residual amount. As discussed further in Section 7.2.3 below, demonstrating the existence of observable stand-alone selling prices for certain software elements (e.g., postcontract customer support (PCS)) may require an analysis that differs from what would be used to demonstrate the existence of VSOE of fair value for undelivered PCS under current U.S. GAAP.

As discussed in paragraph BC272 of ASU 2014-09, the residual approach under the new revenue standard can be used if two or more performance obligations have highly variable or uncertain stand-alone selling prices when they are bundled with other performance obligations that have observable stand-alone selling prices. For example, an entity may enter into a contract to sell a customer two separate software licenses along with professional services and PCS (which are each distinct). The entity may have observable stand-alone selling prices for both the professional services and the PCS, but the stand-alone selling prices of the licenses may be highly variable or uncertain. In such a scenario, the entity might use the residual approach to determine the amount of the transaction price that should be allocated to the two licenses in aggregate and then use another method to further allocate the residual transaction price to each license. When estimating the amount to be allocated to each performance obligation in this way, an entity should consider the guidance in ASC 606-10-32-28 on the objective of allocating the transaction price and the guidance in ASC 606-10-32-33 on estimating stand-alone selling prices.

7.2.3 Examples of Determining the Stand-Alone Selling Price

Q&A 7-1 Stand-Alone Selling Price of Postcontract Support Based on a Stated Renewal Percentage

It is common for software contracts to include both a software license and PCS for a defined term. After the initial PCS term, such contracts will often allow for renewal of PCS at a stated percentage of the contractual license fee (e.g., 20 percent of the initial contractual license fee). Contractual license fees will often vary between customers; consequently, the renewal price for the related PCS also often varies between customers.

ASC 606-10-32-32 states that the "best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers" and that the "contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service." Further, ASC 606-10-32-33 requires entities to estimate the stand-alone selling price when that price is not observable.

Question

In the circumstances described, is it appropriate for an entity to conclude that the price charged for PCS renewal represents the stand-alone selling price of the PCS?

Answer

Not necessarily. Because the actual amount paid for the PCS in these arrangements varies between contracts, it may not represent the "observable price" for the PCS when an entity sells the PCS separately in "similar circumstances and to similar customers." Since the prices vary by individual contract, an entity cannot assume that the price based on the contractually stated renewal rate for each particular contract represents the stand-alone selling price for the PCS, especially when PCS is renewed for a broad range of amounts (regardless of whether the renewal is a consistent percentage of the contractual license fee). As a result, an entity may need to estimate the stand-alone selling price of the PCS in accordance with ASC 606-10-32-33 through 32-35 by considering all of the information that is reasonably available to the entity, such as the actual amounts charged for renewals, the anticipated cost of providing the PCS, internal pricing guidelines, and third-party prices for similar PCS (if relevant). While the range of amounts charged for actual renewals on the basis of the stated rates may be broad, a concentration of those amounts around a particular price may help support a stand-alone selling price.

The stand-alone selling price for a performance obligation does not need to be a single amount. That is, the stand-alone selling price can be a range of amounts if the range is sufficiently narrow and the allocation of the transaction price that results from the identified stand-alone selling price is consistent with the general allocation objective in ASC 606-10-32-28 (i.e., "to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer"). Consequently, if the range of actual PCS renewals is sufficiently narrow, the renewal rate could be used to support the stand-alone selling price of PCS.

Changing Lanes — Renewal Rate Approach

ASC 985-605 provides specific guidance on determining VSOE for PCS by reference to the PCS renewal rate (the "renewal rate approach"). The renewal rate approach allows VSOE for PCS to be established on a contract-by-contract basis if the PCS renewal rate is substantive. This is true even if the same PCS element is renewed for different amounts by different customers. Under current U.S. GAAP, an entity might conclude that it has VSOE for PCS if renewals of PCS are stated at a constant percentage of a license fee, even if the license fee paid by customers (and, therefore, PCS renewals) vary (refer to ASC 985-605-55-69). Because the new revenue standard refers to observable pricing as the amount for which an element is sold on a stand-alone basis to similar customers and in similar circumstances, if an entity's actual stand-alone sales of PCS (i.e., the prices at which PCS is renewed) vary from customer to customer, the renewal rate may not reflect the stand-alone selling price for PCS even if the renewal rate is deemed substantive under current accounting guidance. That is, the prices at which stand-alone sales of PCS occur are not sufficiently concentrated to enable an entity to determine that there is an observable selling price for PCS. Entities may need to estimate the stand-alone selling price for PCS in these situations.

Q&A 7-2 Different Stand-Alone Selling Price for the Same Good or Service in a Single Contract

Entity A enters into a contract to transfer 1,000 units of Product X to a customer each year for three years. The contract requires the customer to pay $10 for each unit delivered in year 1, $11 for each unit in year 2, and $12 for each unit in year 3.

Question

How should A determine the stand-alone selling price for the units of Product X sold in each of years 1, 2, and 3?

Answer

ASC 606-10-32-32 states that "[t]he best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service."

If the contractually stated price is representative of the value of each distinct good or service for the given period (i.e., it is considered to be the same as the stand-alone selling price), an entity could allocate consideration to the performance obligations on the basis of the contract pricing.

In the circumstances under consideration, A should consider the specific facts and circumstances of the arrangement as well as the reason for the different selling prices over the term of the contract. For example, if the contract prices have been set to reflect how the market price of Product X is expected to change over the three-year period, it may be appropriate to use the specified contract price as the stand-alone selling price for Product X in each year of the contract. Conversely, if there is no expectation that the market price of Product X will change over the three-year period, A may need to determine a single stand-alone selling price to be applied throughout the three-year contract term.

Q&A 7-3 Different Selling Price for the Same Product to Different Customers

Entity B enters into contracts to sell Product X to Customers C, D, and E. The contracts are negotiated separately, and each of the customers will pay a different unit price.

Question

How should B determine the stand-alone selling price for the units of Product X sold to C, D, and E, respectively?

Answer

ASC 606-10-32-32 states that "[t]he best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service."

The stand-alone selling price for a performance obligation (or distinct good or service) does not need to be a single amount. If the contractually stated price is representative of the value of each distinct good or service (i.e., it is considered to be the same as the stand-alone selling price), an entity could allocate consideration to the performance obligations on the basis of the contract pricing.

In the circumstances under consideration, B should consider the specific facts and circumstances of the arrangement, as well as the reason for the different selling prices for different customers. There may be important differences between the transactions such that the sales are not in similar circumstances and to similar customers. For example, the transactions may be in different geographical markets or for different committed volumes, or the nature of the customer may be different (e.g., distributor, end user). If the sales are not in similar circumstances and to similar customers, the stand-alone selling price could be different for each customer, and it may be appropriate to use the specified contract price as the stand-alone selling price for each of the customers.

Conversely, if the sales are determined to be in similar circumstances and with similar customers, B may determine there should be a single stand-alone selling price for all three customers on the basis of other market evidence. It would then use that price to allocate the transaction price of the contracts with C, D, and E between Product X and any other performance obligations in those contracts, including when it applies ASC 606-10-32-36 through 32-38 to any discounts given against that stand-alone selling price.

Driving Discussion — Determining the Stand-Alone Selling Price for Multiperiod Commodity Contracts

Entities in commodities industry sectors, specifically oil and gas, power and utilities, mining and metals, and agriculture, often enter into multiyear contracts with their customers to provide commodities at a fixed price per unit. For example, an entity may enter into a contract to provide its customer 10,000 barrels of oil per month at a fixed price of $50 per barrel. For certain types of commodities, there may be a forward commodity pricing curve and actively traded contracts that establish pricing for all of or a portion of the contract duration. The forward commodity pricing curve may provide an indication of the price at which an entity could currently buy or sell a specified commodity for delivery in a specific month.

Sometimes, "strip" pricing may be available. In strip pricing, a single price is used to represent a single-price "average" of the expectations of the individual months in the strip period, which is typically referred to as a seasonal or annual strip. Terms of the multiperiod contracts are often derived, in part, in contemplation of the forward commodity pricing curve.

Certain arrangements may not meet the criteria in ASC 606-10-25-15 to be accounted for as a series of distinct goods that have the same pattern of transfer to the customer (and, therefore, as a single performance obligation). In these situations, when each commodity delivery is determined to be distinct, stakeholders have questioned whether entities are required to use the forward commodity pricing curve, the spot price, or some other value as the stand-alone selling price for allocating consideration to multiperiod commodity contracts.

We believe that entities should consider all of the relevant facts and circumstances, including market conditions, entity-specific factors, and information about the customer, in determining the stand-alone selling price of each promised good. We do not believe that entities should default to forward-curve pricing in determining the stand-alone selling price; however, certain situations may indicate that the forward curve provides the best indicator of the stand-alone selling price. In other circumstances, the contract price may reflect the stand-alone selling price for the commodity deliveries under a particular contract. The determination of the contract price and the resulting allocation of the transaction price needs to be consistent with the overall allocation objective (i.e., to allocate the transaction price to each distinct good or service in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the goods or services to the customer). Entities will need to use significant judgment in determining the stand-alone selling price in these types of arrangements.

7.3 Allocation of a Discount

It is not uncommon for contracts containing multiple goods and services to include a discounted bundled price rather than the sum of the individual goods' or services' respective stand-alone selling prices (see the example in Section 7.1). In accordance with the general allocation principle discussed in Section 7.1, the discounted transaction price is allocated proportionately to each distinct good and service on the basis of its relative stand-alone selling price of the individual good or service. However, there may be instances in which the result of this allocation approach does not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for the underlying goods or services. That is, the allocation approach may result in revenue recognition that is inconsistent with the core principle in the new revenue standard. This may occur, for example, if certain goods or services are routinely sold at a very low margin while others are routinely sold at a very high margin. An entity may routinely discount the high-margin goods or services but not discount the low-margin goods or services. Allocating a discount proportionately to these goods or services may result in an allocated amount that does not accurately depict the amount of consideration to which the entity expects to be entitled in exchange for the goods or services. Consequently, ASC 606-10-32-37 provides an exception for allocating a discount to one or more, but not all, distinct goods or services in a contract if certain criteria are met.

ASC 606-10

32-36 A customer receives a discount for purchasing a bundle of goods or services if the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence in accordance with paragraph 606-10-32-37 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

32-37 An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.
b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

32-38 If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 606-10-32-37, an entity shall allocate the discount before using the residual approach to estimate the standalone selling price of a good or service in accordance with paragraph 606-10-32-34(c).

Paragraph BC283 of ASU 2014-09 summarizes the views of the FASB and IASB on the application of ASC 606-10-32-37:

> The Boards . . . noted that [ASC] 606-10-32-37 would typically apply to contracts for which there are at least three performance obligations. This is because an entity could demonstrate that a discount relates to two or more performance obligations when it has observable information supporting the standalone selling price of a group of those promised goods or services when they are sold together. The Boards noted it may be possible for an entity to have sufficient evidence to be able to allocate a discount to only one performance obligation in accordance with the criteria in [ASC] 606-10-32-37, but the Boards expected that this could occur in only rare cases.

Q&A 7-4 Allocating a Discount

ASC 606-10-32-37 states the following:

> An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:
>
> a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.
>
> b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
>
> c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

Example 1

Entity W sells Item A, Item B, and Item C. The stand-alone selling price (SSP) of each item is shown in the following table:

Item	SSP
A	$ 30
B	70
C	50

On January 1, 20X1, W enters into a contract with a customer to provide the customer with one of each item for consideration of $135 (a $15 discount) in accordance with the following schedule:

Date	Deliverable
3/31/X1	Item A
6/30/X1	Item B
9/30/X1	Item C

Assume that W also sells bundles regularly at combined prices as follows:

Bundle	Price	Combined SSP	Discount in Bundle
A + B	$ 85	$30 + $70 = $100	$ 15
A + C	65	$30 + $50 = $80	15
B + C	105	$70 + $50 = $120	15

Question

How should the entity allocate the discount in the contract?

Answer

On the basis of the selling prices of the bundled goods, the entity does **not** have sufficient evidence to demonstrate that the discount in the contract is related to any specific performance obligation (i.e., the evidence does not support a determination that the discount is anything more than a volume-based discount attributable to a customer's purchase of a bundle of items).

Accordingly, the discount of $15 should be allocated pro rata to each of the performance obligations on the basis of their individual stand-alone selling prices as follows:

Item	SSP	% of Total SSP	Total Discount to Allocate	Discount Allocated
A	$ 30	20.0	$ 15	$ 3
B	70	46.7	15	7
C	50	33.3	15	5
	$ 150			$ 15

The entity would therefore recognize revenue as follows:

- When Item A is transferred, recognize revenue of $27 ($30 – $3).
- When Item B is transferred, recognize revenue of $63 ($70 – $7).
- When Item C is transferred, recognize revenue of $45 ($50 – $5).

Thus, the total revenue recognized on the contract is $135 ($27 + $63 + $45).

Example 2

Assume the same facts as in Example 1, except that the entity regularly sells bundles at combined prices as follows:

Bundle	Price	Combined SSP	Discount in Bundle
A + B	$ 85	$30 + $70 = $100	$ 15
A + C	65	$30 + $50 = $80	15
B + C	120	$70 + $50 = $120	0

Question

How should the entity allocate the discount in the contract?

Answer

In this scenario, the evidence based on the selling prices of the bundled goods supports a determination that (1) there is a discount of $15 when the entity sells a bundle of two items that includes Item A and (2) there is a discount of $0 for all other bundles that contain items other than Item A. Consequently, it is reasonable to conclude that the discount of $15 should be allocated entirely to Item A in accordance with ASC 606-10-32-37.

The entity would recognize revenue as follows:

- When Item A is transferred, recognize revenue of $15 ($30 (stand-alone selling price of Item A) – $15 (full discount)).
- When Item B is transferred, recognize revenue of $70.
- When Item C is transferred, recognize revenue of $50.

Thus, the total revenue recognized on the contract is $135 ($15 + $70 + $50).

Thinking It Through — Whether Allocating a Discount to One or More, but Not All, of the Performance Obligations Is Required

Entities often sell their goods and services in bundles priced at a discount instead of selling each good or service separately. Stakeholders have questioned whether the guidance in ASC 606-10-32-37 on allocating discounts to one or more, but not all, of the performance obligations is a requirement (i.e., whether an entity needs to prove that it does not meet the criteria in ASC 606-10-32-37 to allocate a discount proportionately to all of the performance obligations). Some stakeholders believe that the guidance is a requirement and that an entity would need to demonstrate that it does not meet the criteria in ASC 606-10-32-37 to allocate the discount proportionately to all of the performance obligations. However, other stakeholders believe that an entity can choose, as an accounting policy, to allocate a discount proportionately to all (as opposed to one or more, but not all) of the performance obligations if it meets the criteria.

We believe that if the criteria in ASC 606-10-32-37 are met, an entity should allocate a discount to one or more, but not all, of the performance obligations in a contract. We believe that failing to do so would result in an allocation that is inconsistent with the core allocation principle of ASC 606 — namely, that an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.

The level of effort required to determine whether the criteria in ASC 606-10-32-37 are met will depend on the entity's specific facts and circumstances. Often, an entity's established pricing practice or customary business practices will provide sufficient evidence that the criteria in ASC 606-10-32-37 are met (or not met). However, in certain circumstances, it may not be evident that those criteria are met (or not met), and an entity may therefore be required to perform further analysis. Even so, we do not believe that an entity must perform an exhaustive analysis to prove that the criteria in ASC 606-10-32-37 are not met before it can apply the general allocation guidance in ASC 606-10-32-29 (i.e., allocate the discount proportionately to the performance obligations).

However, in determining whether the criteria in ASC 606-10-32-37 are met, an entity should not ignore information that is reasonably available without undue cost and effort. The process of evaluating whether the criteria in ASC 606-10-32-37 are met (or not met) may be similar to the process an entity would have in place to evaluate the selling price hierarchy required by current U.S. GAAP in ASC 605-25-30-2. Entities may need to document their pricing strategies for each good or service (which may be part of the determination of stand-alone selling prices for each good or service), including (1) how the goods or services are marketed, (2) internally communicated pricing guidelines, (3) relative direct costs attributed to goods or services, and (4) relevant market information.

Entities may also need to assess their internal controls to evaluate the manner in which they adhere to the requirement in ASC 606-10-32-37. An entity should develop a reasonable approach to evaluating how discounts should be allocated, and it should apply that approach consistently to similar contracts and in similar circumstances.

7.3.1 Allocation of a Premium or Surplus

Q&A 7-5 How to Allocate a Premium or Surplus Resulting From Promised Consideration That Exceeds the Sum of the Stand-Alone Selling Prices

Entities often enter into arrangements for which the sum of the stand-alone selling prices of the individual performance obligations exceeds the transaction price. ASC 606-10-32-36 requires any discount under the contract to be allocated proportionately to all performance obligations unless an entity has observable evidence that the entire discount is related only to one or more, but not all, of the performance obligations in the contract. ASC 606-10-32-37 specifies the criteria an entity must meet to conclude that the discount does not need to be allocated proportionately to all performance obligations.

However, ASC 606 does not explicitly discuss situations in which the transaction price exceeds the sum of the stand-alone selling prices of the individual performance obligations, which would suggest that a customer is paying a surplus or a premium for purchasing the goods or services.

Question

How should an entity allocate a premium or surplus resulting from promised consideration under a contract that exceeds the sum of the stand-alone selling prices of the contract's performance obligations?

Answer

This scenario is expected to be relatively uncommon, and before assessing how to allocate a premium or surplus, an entity should determine whether an apparent surplus indicates that an error, such as one of the following, has been made in the analysis:

- A significant financing component in the contract has not been identified.
- The contract includes an incentive (i.e., performance bonus) that has not been identified or properly constrained.
- Additional performance obligations have not been identified.
- The stand-alone selling prices of performance obligations have not been correctly identified.

If, after further assessment, it is determined that a premium or surplus exists, the entity should allocate that premium in a manner consistent with the requirements of ASC 606 for allocation of a discount (i.e., on a relative stand-alone selling-price basis in accordance with ASC 606-10-32-29, subject to the exception in ASC 606-10-32-36 through 32-38).

7.3.2 Example of Allocating a Discount

The example below, which is reproduced from ASC 606, illustrates how an entity would allocate a discount when there are multiple performance obligations.

ASC 606-10

Example 34 — Allocating a Discount

55-259 An entity regularly sells Products A, B, and C individually, thereby establishing the following standalone selling prices:

Product	Standalone Selling Price
Product A	$ 40
Product B	55
Product C	45
Total	$ 140

55-260 In addition, the entity regularly sells Products B and C together for $60.

Case A — Allocating a Discount to One or More Performance Obligations

55-261 The entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time.

55-262 The contract includes a discount of $40 on the overall transaction, which would be allocated proportionately to all 3 performance obligations when allocating the transaction price using the relative standalone selling price method (in accordance with paragraph 606-10-32-36). However, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37.

55-263 If the entity transfers control of Products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate $60 of the transaction price to the single performance obligation and recognize revenue of $60 when Products B and C simultaneously transfer to the customer.

ASC 606-10 (continued)

55-264 If the contract requires the entity to transfer control of Products B and C at different points in time, then the allocated amount of $60 is individually allocated to the promises to transfer Product B (standalone selling price of $55) and Product C (standalone selling price of $45) as follows:

Product	Allocated Transaction Price	
Product B	$ 33	($55 ÷ $100 total standalone selling price × $60)
Product C	27	($45 ÷ $100 total standalone selling price × $60)
Total	$ 60	

Case B — Residual Approach Is Appropriate

55-265 The entity enters into a contract with a customer to sell Products A, B, and C as described in Case A. The contract also includes a promise to transfer Product D. Total consideration in the contract is $130. The standalone selling price for Product D is highly variable (see paragraph 606-10-32-34(c)(1)) because the entity sells Product D to different customers for a broad range of amounts ($15 – $45). Consequently, the entity decides to estimate the standalone selling price of Product D using the residual approach.

55-266 Before estimating the standalone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 606-10-32-37 through 32-38.

55-267 As in Case A, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has observable evidence that $100 should be allocated to those 3 products and a $40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37. Using the residual approach, the entity estimates the standalone selling price of Product D to be $30 as follows:

Product	Standalone Selling Price	Method
Product A	$ 40	Directly observable (see paragraph 606-10-32-32)
Products B and C	60	Directly observable with discount (see paragraph 606-10-32-37)
Product D	30	Residual approach (see paragraph 606-10-32-34(c))
Total	$ 130	

55-268 The entity observes that the resulting $30 allocated to Product D is within the range of its observable selling prices ($15 – $45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 606-10-32-28 and the guidance in paragraph 606-10-32-33.

Case C — Residual Approach Is Inappropriate

55-269 The same facts as in Case B apply to Case C except the transaction price is $105 instead of $130. Consequently, the application of the residual approach would result in a standalone selling price of $5 for Product D ($105 transaction price less $100 allocated to Products A, B, and C). The entity concludes that $5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D because $5 does not approximate the standalone selling price of Product D, which ranges from $15 – $45. Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the standalone selling price of Product D using another suitable method. The entity allocates the transaction price of $105 to Products A, B, C, and D using the relative standalone selling prices of those products in accordance with paragraphs 606-10-32-28 through 32-35.

7.4 Allocation of Variable Consideration

As discussed in Section 7.3, there may be instances in which applying the relative stand-alone selling price allocation principle could result in the recognition of revenue that does not depict the amount of consideration to which an entity expects to be entitled in exchange for goods or services. This could occur when the criteria for allocating a discount to one or more, but not all, performance obligations are met. Another example is when a contract includes variable consideration and meets certain criteria for allocating the variable consideration to one or more, but not all, performance obligations. This additional exception to the general allocation requirements is discussed in the following paragraphs of ASC 606:

ASC 606-10

32-39 Variable consideration that is promised in a contract may be attributable to the entire contract or to a specific part of the contract, such as either of the following:

a. One or more, but not all, performance obligations in the contract (for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time)
b. One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

32-40 An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

32-41 The allocation requirements in paragraphs 606-10-32-28 through 32-38 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 606-10-32-40.

TRG Update — Allocating Variable Consideration and Discounts

In some circumstances, a contract may include both a discount and variable consideration. The new revenue standard includes guidance on allocating discounts to only one or some, but not all, performance obligations, which differs from the guidance on allocating variable consideration to one or some, but not all, performance obligations. Because discounts may be in the form of variable consideration (e.g., the new revenue standard cites discounts as examples of variable consideration), stakeholders have questioned which guidance should be applied when an entity's contract with a customer includes a discount.

In March 2015, the TRG discussed this issue and generally supported the view that an entity would first determine whether a discount is variable consideration. If the entity concludes that the discount is variable consideration, it would apply the variable consideration allocation guidance if the related criteria are met and then apply the allocation guidance in ASC 606-10-32-28 through 32-38 (which includes the guidance on allocating discounts) to the remaining amount of the transaction price. If the discount is not variable, the entity would look to the discount allocation guidance to determine how to allocate the discount.

This issue is further discussed in the Q&A below.

Q&A 7-6 Allocation of Transaction Price for Discounts and Variable Consideration

Consider the following:

- An entity enters into a contract with a customer that includes Product A and Product B.
- The stand-alone selling price of Product A is $100, and the stand-alone selling price of Product B is $200.
- The contract includes fixed consideration of $225 and a performance bonus of $50 if certain conditions are met.
- The performance bonus is related to the productivity enhancements that Product B achieves.

As indicated above, the contract includes both a discount and variable consideration. Because of the performance bonus, the determination of the transaction price will result in either of the following possible outcomes:

	Outcome 1	Outcome 2
Fixed consideration	$ 225	$ 225
Variable consideration	0	50
Total transaction price	225	275
Stand-alone selling price	300	300
Discount	75	25

Question

How should an entity apply the allocation guidance when a contract includes both a discount and variable consideration?

Answer

When a contract includes both a discount and variable consideration, an entity would first apply the variable consideration allocation guidance in ASC 606-10-32-39 through 32-41 to determine whether the criteria for allocating the variable consideration to one or more (but not all) of the performance obligations are met. After considering the guidance on allocating variable consideration, the entity would look to the discount allocation guidance to determine how to allocate the discount. ASC 606-10-32-41 establishes a hierarchy that requires an entity to identify and allocate variable consideration to performance obligations before applying other guidance (e.g., the guidance on allocating a discount).

In the example above, because the performance bonus is related to productivity enhancements achieved by Product B, the entity concludes that the criteria in ASC 606-10-32-40 are met and allocates the variable consideration entirely to Product B. The entity would then apply the guidance in ASC 606-10-32-28 through 32-38 to allocate the remaining consideration to Products A and B.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

Driving Discussion — Allocating Discounts When Variable Consideration Has Already Been Allocated

As noted above in Q&A 7-6, an entity would first consider whether variable consideration should be allocated to a single performance obligation. Only after doing so would an entity consider whether there is any remaining discount and, if so, allocate that amount in accordance with the normal allocation guidance on discounts. However, stakeholders have expressed several views on how to determine the amount that represents a discount rather than variable consideration:

- *View 1* — The entity should determine the remaining discount, if any, that is a fixed discount (i.e., the amount of the discount that is present in the contract regardless of the outcome of the uncertainties that give rise to variable consideration). In determining the fixed discount in an arrangement, an entity should compare the combined stand-alone selling prices of the performance obligations with the sum of the fixed consideration and any potential variable consideration, including variable consideration that has been specifically allocated to a performance obligation. In determining potential variable consideration (i.e., the top end of the potential consideration), the entity should not include amounts that are not realistic outcomes (i.e., there should be substance to the potential variable consideration). Accordingly, when the likelihood of receiving certain amounts of variable consideration is sufficiently low, the entity should exclude those amounts from the transaction price when determining the portion of the discount that is essentially a fixed discount. In Q&A 7-6 above, this approach would result in a fixed discount of $25 (i.e., the total stand-alone selling price of $300 minus the total potential consideration of $275) that would be allocated to Product A and Product B in accordance with the guidance in ASC 606-10-32-36 through 32-38 as follows:

						Potential Revenue	
	SSP	Relative SSP	Allocated Fixed Discount	Total Potential Transaction Price	Allocated Variable Consideration	Outcome 1 (No Bonus)	Outcome 2 (Bonus of $50)
Product A	$ 100	33%	$ (8.33)	$ 91.67	$ —	$ 91.67	$ 91.67
Product B	200	67%	(16.67)	183.33	50.00	133.33	183.33
Total	$ 300		$ (25.00)	$ 275.00	$ 50.00	$ 225.00	$ 275.00

  Under View 1, $91.67 would be recognized when control of Product A is transferred to the customer. If the entity concludes that it is probable that including the performance bonus in the transaction price will not result in a significant revenue reversal, the entity would recognized $183.33 as revenue when control of Product B is transferred to the customer. Any subsequent changes in the transaction price would be attributed entirely to Product B.

- *View 2* — The entity should calculate the remaining discount by comparing the combined stand-alone selling prices of the performance obligations with the transaction price. The transaction price should include the fixed element (i.e., $225) plus an estimate of the variable consideration determined in accordance with ASC 606-10-32-8; that estimate should be made *before the application of the constraints* under ASC 606-10-32-11 or ASC 606-10-55-65. Assuming that the amounts discussed in Q&A 7-6 above are used across a portfolio of homogeneous contracts, if the entity estimates that it would be entitled to a performance bonus of $40 (determined in accordance with ASC 606-10-32-8), a remaining discount of $35 (i.e., the total stand-alone selling price of $300 minus the expected consideration of $265) would be allocated to Products A and B in accordance with the guidance in ASC 606-10-32-36 through 32-38 as follows:

						Potential Revenue	
	SSP	Relative SSP	Allocated Remaining Discount	Total Expected Transaction Price	Allocated Variable Consideration	Outcome 1 (No Bonus)	Outcome 2 (Bonus of $50)
Product A	$ 100	33%	$ (11.67)	$ 88.33	$ —	$ 83.33	$ 88.33
Product B	200	67%	(23.33)	176.67	40.00	136.67	186.67
Total	$ 300		$ (35.00)	$ 265.00	$ 40.00	$ 225.00	$ 275.00

Under View 2, $88.33 would be recognized when control of Product A is transferred to the customer. If the entity concludes that it is probable that including the performance bonus in the transaction price will not result in a significant revenue reversal, the entity would recognized $186.67 as revenue when control of Product B is transferred to the customer. Any subsequent changes in the transaction price would be attributed entirely to Product B.

- *View 3* — The entity should calculate the remaining discount by comparing the combined stand-alone selling prices of the performance obligations with the transaction price. The transaction price should include the fixed element (i.e., $225) plus an estimate of the variable consideration determined in accordance with ASC 606-10-32-8, subject to the variable consideration constraints under ASC 606-10-32-11 or ASC 606-10-55-65. If the amounts discussed in Q&A 7-6 above are used across a portfolio of homogeneous contracts and only $30 of the performance bonus of $50 is included in the transaction price (i.e., the constrained amount of variable consideration), a remaining discount of $45 (i.e., the total stand-alone selling price of $300 minus the constrained transaction price of $255) would be allocated to Products A and B in accordance with the guidance in ASC 606-10-32-36 through 32-38 as follows:

						Potential Revenue	
	SSP	Relative SSP	Allocated Remaining Discount	Total Constrained Transaction Price	Allocated Variable Consideration	Outcome 1 (No Bonus)	Outcome 2 (Bonus of $50)
Product A	$ 100	33%	$ (15.00)	$ 85.00	$ —	$ 85.00	$ 85.00
Product B	200	67%	(30.00)	170.00	30.00	140.00	190.00
Total	$ 300		$ (45.00)	$ 255.00	$ 30.00	$ 225.00	$ 275.00

Under View 3, $85 would be recognized when control of Product A is transferred to the customer. If the entity concludes that it is probable that including the performance bonus in the transaction price will not result in a significant revenue reversal, the entity would recognized $190 as revenue when control of Product B is transferred to the customer. Any subsequent changes in the transaction price would be attributed entirely to Product B.

The new revenue standard does not prescribe a method for determining the amount of remaining consideration to allocate once variable consideration has been allocated in accordance with ASC 606-10-32-39 through 32-41. An entity should use judgment and consider a contract's specific facts and circumstances when deciding which of the above alternatives would best achieve the allocation objective, which is to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.

In the determination of which approach to use, it may be relevant to consider whether the stand-alone selling price of one or more of the goods or services is actually a range of amounts (which may be the case if variable consideration is appropriately allocated to one or more, but not all, performance obligations in a contract). For instance, if the stand-alone selling price of B in the above example was determined to be between $150 and $200, View 1 may be the most appropriate approach. This is because the discount allocated to both A and B under either outcome results in an amount of revenue recognized for each performance obligation that is (1) consistent with the overall allocation objective and (2) based on the relative stand-alone selling prices of A and B. Depending on the specific facts and circumstances, different approaches may be more or less appropriate.

It will also be important to evaluate the potential outcomes of any resulting allocation approach. For example, in situations involving both a fixed discount and variable consideration (i.e., the total potential transaction price is less than the aggregated stand-alone selling prices), we do not think that an allocation that could result in the allocation of consideration to a performance obligation in an amount that exceeds the performance obligation's stand-alone selling price would be consistent with the overall allocation objectives.

7.4.1 Example of Allocating Variable Consideration

The example below, which is reproduced from ASC 606, illustrates how an entity would allocate variable consideration.

ASC 606-10

Example 35 — Allocation of Variable Consideration

55-270 An entity enters into a contract with a customer for two intellectual property licenses (Licenses X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The standalone selling prices of Licenses X and Y are $800 and $1,000, respectively.

Case A — Variable Consideration Allocated Entirely to One Performance Obligation

55-271 The price stated in the contract for License X is a fixed amount of $800, and for License Y the consideration is 3 percent of the customer's future sales of products that use License Y. For purposes of allocation, the entity estimates its sales-based royalties (that is, the variable consideration) to be $1,000, in accordance with paragraph 606-10-32-8.

ASC 606-10 (continued)

55-272 To allocate the transaction price, the entity considers the criteria in paragraph 606-10-32-40 and concludes that the variable consideration (that is, the sales-based royalties) should be allocated entirely to License Y. The entity concludes that the criteria in paragraph 606-10-32-40 are met for the following reasons:

a. The variable payment relates specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y).
b. Allocating the expected royalty amounts of $1,000 entirely to License Y is consistent with the allocation objective in paragraph 606-10-32-28. This is because the entity's estimate of the amount of sales-based royalties ($1,000) approximates the standalone selling price of License Y and the fixed amount of $800 approximates the standalone selling price of License X. The entity allocates $800 to License X in accordance with paragraph 606-10-32-41. This is because, based on an assessment of the facts and circumstances relating to both licenses, allocating to License Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 606-10-32-28.

55-273 The entity transfers License Y at inception of the contract and transfers License X one month later. Upon the transfer of License Y, the entity does not recognize revenue because the consideration allocated to License Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph 606-10-55-65, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

55-274 When License X is transferred, the entity recognizes as revenue the $800 allocated to License X.

Case B — Variable Consideration Allocated on the Basis of Standalone Selling Prices

55-275 The price stated in the contract for License X is a fixed amount of $300, and for License Y the consideration is 5 percent of the customer's future sales of products that use License Y. The entity's estimate of the sales-based royalties (that is, the variable consideration) is $1,500 in accordance with paragraph 606-10-32-8.

55-276 To allocate the transaction price, the entity applies the criteria in paragraph 606-10-32-40 to determine whether to allocate the variable consideration (that is, the sales-based royalties) entirely to License Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y), allocating the variable consideration entirely to License Y would be inconsistent with the principle for allocating the transaction price. Allocating $300 to License X and $1,500 to License Y does not reflect a reasonable allocation of the transaction price on the basis of the standalone selling prices of Licenses X and Y of $800 and $1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 606-10-32-31 through 32-35.

55-277 The entity allocates the transaction price of $300 to Licenses X and Y on the basis of relative standalone selling prices of $800 and $1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative standalone selling price basis. However, in accordance with paragraph 606-10-55-65, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

55-278 License Y is transferred to the customer at the inception of the contract, and License X is transferred three months later. When License Y is transferred, the entity recognizes as revenue the $167 ($1,000 ÷ $1,800 × $300) allocated to License Y. When License X is transferred, the entity recognizes as revenue the $133 ($800 ÷ $1,800 × $300) allocated to License X.

55-279 In the first month, the royalty due from the customer's first month of sales is $200. Consequently, in accordance with paragraph 606-10-55-65, the entity recognizes as revenue the $111 ($1,000 ÷ $1,800 × $200) allocated to License Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the $89 ($800 ÷ $1,800 × $200) allocated to License X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

TRG Update — Allocating Variable Consideration to a Series of Distinct Services

The new revenue standard includes a provision that requires an entity to identify as a performance obligation a promise to transfer a "series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer" (see Section 5.3.3). As noted above, the new revenue standard requires the allocation of variable consideration to one or more, but not all, of the distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with ASC 606-10-25-14(b) (the "series guidance") when the criteria in ASC 606-10-32-40 are met.

Stakeholders have questioned whether an entity is required to allocate variable consideration on the basis of the relative stand-alone selling price of each distinct good or service in a series accounted for as a single performance obligation under ASC 606-10-25-14(b). If an entity is required to do so, applying the series guidance would not result in the relief contemplated by the FASB and IASB, as discussed in paragraph BC114 of ASU 2014-09. Such an outcome would largely nullify the benefits of qualifying for the series guidance since the same amount of consideration would most likely be allocated to each distinct good or service that is "substantially the same" (because goods or services that are substantially the same would most likely have the same stand-alone selling prices). However, a distinct increment of service that forms part of a single performance obligation may be substantially the same but have varying stand-alone selling prices (see Section 5.3.3 on evaluating whether distinct goods and services accounted for under the series guidance are substantially the same), and allocating the variable consideration (or changes in variable consideration) entirely to this discrete increment of service may be consistent with the allocation objective in ASC 606-10-32-28.

As stated in ASC 606-10-32-29, the general allocation principle does not apply if the criteria in ASC 606-10-32-39 through 32-41 are met. The FASB and IASB staffs concluded that a relative stand-alone selling price allocation is not required to meet the allocation objective when it is related to the allocation of variable consideration to a distinct good or service in a series. TRG members generally agreed with the staffs.

The application of this allocation concept is further explained in paragraph BC285 of ASU 2014-09, which states, in part:

> Consider the example of a contract to provide hotel management services for one year (that is, a single performance obligation in accordance with [ASC] 606-10-25-14(b)) in which the consideration is variable and determined based on two percent of occupancy rates. The entity provides a daily service of management that is distinct, and the uncertainty related to the consideration also is resolved on a daily basis when the occupancy occurs. In those circumstances, the Boards did not intend for an entity to allocate the variable consideration determined on a daily basis to the entire performance obligation (that is, the promise to provide management services over a one-year period). Instead, the variable consideration should be allocated to the distinct service to which the variable consideration relates, which is the daily management service.

The above example illustrates a scenario in which the same service (hotel management) is performed each day for varying amounts (because occupancy rates change each day). If it was determined that each day of service should have the same stand-alone selling price, an entity might have to estimate the total transaction price for the contract (on the basis of the expected occupancy rates and associated fees over the term of the arrangement) and allocate that transaction price to each distinct increment of service. However, as explained in paragraph

BC285, this was not the boards' intent. Rather, variability in the actual amounts earned each day based on occupancy rates can be allocated to that day's service without regard to a perceived stand-alone selling price of the service provided. In all scenarios, however, the resulting allocation would need to meet the overall allocation objective.

Construction Ahead — Proposed Disclosure Practical Expedient

Stakeholders have raised concerns regarding the need to disclose the amount of the transaction price that is allocated to remaining performance obligations when (1) the remaining performance obligations form part of a series, (2) the transaction price includes an amount of variable consideration, and (3) the entity meets the criteria in ASC 606-10-32-40 for allocating the variable amount entirely to a distinct good or service that forms part of a single performance obligation. In these situations, an entity may be required to estimate the amount of variable consideration to include in the transaction price only for disclosure purposes. That is because any remaining variability in the transaction price would be related entirely to unsatisfied portions of a single performance obligation. To address stakeholder concerns, the FASB included in its May 18, 2016, proposed ASU on technical corrections and improvements a proposal to add a practical expedient to the new revenue standard's disclosure requirements. The proposed practical expedient would provide relief from the requirement to disclose the amount of variable consideration included in the transaction price that is allocated to outstanding performance obligations when either of the following conditions is met:

- The variability is related to a sales- or usage-based royalty.
- The variable consideration is allocated entirely to unsatisfied performance obligations or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation for which the criteria in 606-10-32-40 are met.

Entities electing the practical expedient would still need to disclose any fixed consideration allocated to outstanding performance obligations. At the August 31, 2016, FASB meeting, the Board instructed its staff to conduct additional research and outreach related to this potential change. See Chapter 19 for further discussion of the proposed ASU.

7.5 Changes in the Transaction Price

As discussed in Chapter 6, an entity needs to determine a contract's transaction price so that it can be allocated to the performance obligations in the contract. This determination is made at contract inception. However, after contract inception, the transaction price could change for various reasons (e.g., changes in an estimate of variable consideration). Generally, any change in the transaction price should be allocated to the performance obligations on the same basis used at contract inception. For example, if the criteria for allocating variable consideration to one or more, but not all, performance obligations are met, changes in the amount of variable consideration to which the entity expects to be entitled would be allocated to such performance obligation(s) on the same basis. If the criteria for allocating variable consideration to one or more, but not all, performance obligations are not met, changes in the transaction price after contract inception would be allocated to all of the performance obligations in the contract on the basis of the initial relative stand-alone selling prices. An entity would not reallocate the transaction price for changes in stand-alone selling prices after contract inception.

For changes in the transaction price that arise as a result of a contract modification, an entity should apply the guidance on contract modifications in ASC 606-10-25-10 through 25-13 (see Section 9.4). However, if the transaction price changes after a contract modification, an entity would allocate the change as follows:

- The change in the transaction price is allocated to a performance obligation that was identified before the contract modification when (1) the change in the transaction price is attributable to variable consideration related to that performance obligation and (2) the contract modification is accounted for as if the contract was terminated and a new contract was entered into (see ASC 606-10-25-13(a)).
- In all other situations, the change in the transaction price is allocated to the unsatisfied or partially satisfied performance obligations that were identified after the contract modification.

ASC 606-10

32-42 After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

32-43 An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in standalone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

32-44 An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) only if the criteria in paragraph 606-10-32-40 on allocating variable consideration are met.

32-45 An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).

b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

7.6 Other Allocation Considerations

TRG Update — Allocation of Significant Financing Components

Under step 3 of the new revenue recognition model, an entity may need to adjust its transaction price for the existence of a significant financing component (see Section 6.3). ASC 606-10-32-15 requires an entity to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer (see Section 6.3). In those circumstances, the contract contains a significant financing component.

Stakeholders raised concerns about how to apply the significant financing component guidance when a contract with a customer includes multiple performance obligations. Specifically, stakeholders questioned whether the adjustment to the transaction price resulting from a significant financing arrangement could be allocated to one or more, but not all, performance obligations.

In March 2015, the TRG discussed this issue and generally supported the view that an entity may analogize to either the guidance on the allocation of a discount or the guidance on the allocation of variable consideration in its determination of whether and, if so, when it is appropriate to allocate the transaction price adjustment resulting from a significant financing component to one or more, but not all, performance obligations.

This issue is further discussed in the Q&A below.

Q&A 7-7 Allocation of a Significant Financing Component in a Contract With Multiple Performance Obligations

Question

Could an adjustment for a significant financing component ever be attributed to one or more, but not all, of the performance obligations in a contract?

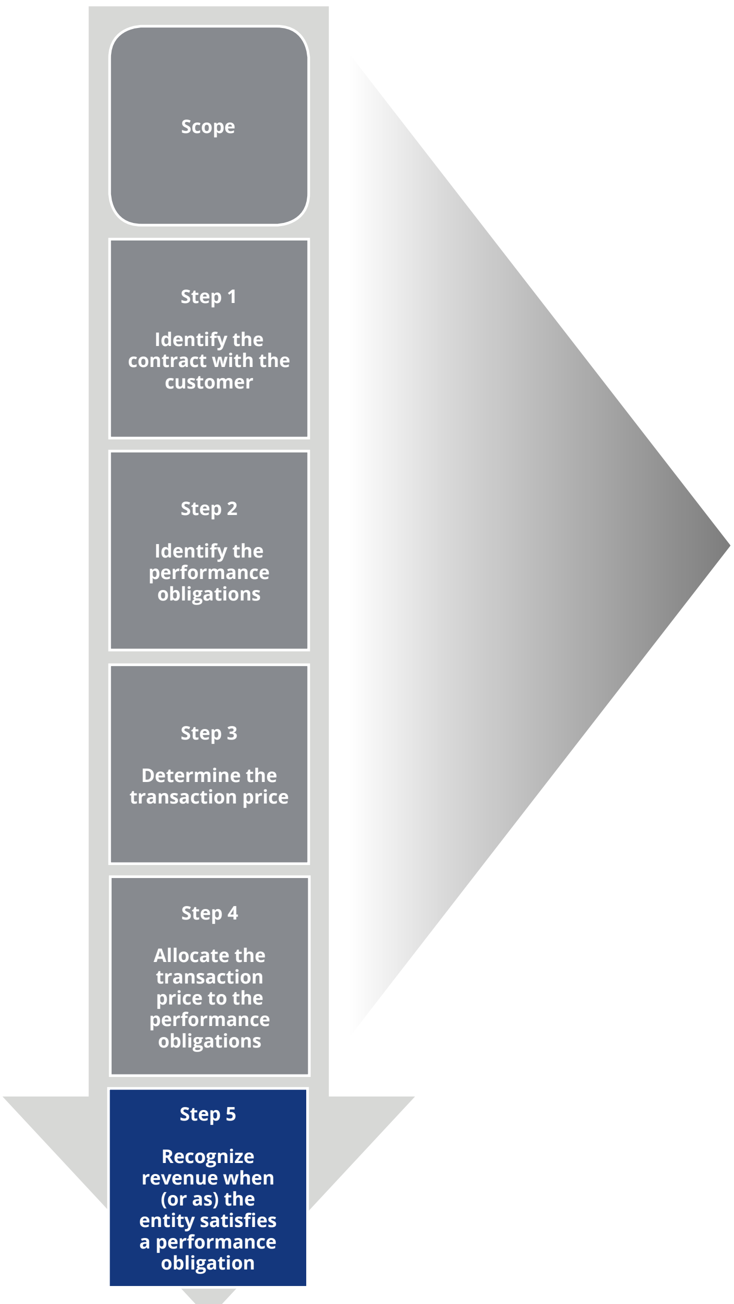
Answer

Yes. Generally, a significant financing component in a contract is related to the contract as a whole rather than to the individual performance obligations in the contract. However, it may be reasonable in some circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. As a practical matter, when an entity considers the basis for such attribution, it may be appropriate for the entity to analogize to (1) the guidance in ASC 606-10-32-36 through 32-38 on allocating a discount or (2) the guidance in ASC 606-10-32-39 through 32-41 on allocating variable consideration.

An entity that is considering the possibility of attributing a significant financing component to one or more, but not all, of the performance obligations in a contract will need to use judgment in determining whether such an approach is reasonable in the particular circumstances of that contract.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

Chapter 8 — Step 5: Determine When to Recognize Revenue



8.1 Objective and Background

ASC 606-10

25-23 An entity shall recognize revenue when (or as) the entity satisfies a performance obligation 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 of that asset.

8.1.1 Concept of Control

In a manner consistent with the core principle of the new revenue standard — "an entity shall **recognize revenue to depict the transfer of promised goods or services to customers** in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services" (emphasis added) — step 5 focuses on recognition (i.e., **when** it is appropriate to recognize revenue). While steps 1 and 2 (see Chapters 4 and 5) also contain recognition concepts, step 5 is the central tenet of the recognition principle in the new standard.

Current revenue guidance draws on the notions of "**earned**" and "**realized or realizable**" in FASB Concepts Statement 5. In addition, it is often necessary in current practice to evaluate the four criteria in SAB Topic 13 of SEC guidance:

- "Persuasive evidence of an arrangement exists."
- "Delivery has occurred or services have been rendered."
- "The seller's price to the buyer is fixed or determinable."
- "Collectibility is reasonably assured."

Among those requirements, the recognition notion of "earned" and the criterion that "delivery has occurred or services have been rendered" require an entity to assess whether the risks and rewards of ownership have been transferred so that it can determine whether to recognize revenue. That is, the recognition point under current U.S. GAAP is based on a completion of the earning process as evidenced by the transfer of substantially all of the risks and rewards to the customer.

In contrast, the new revenue standard requires an entity to assess whether the customer has obtained **control** of the good or service to determine whether the good or service has been transferred to the customer.

Determining **when** revenue should be recognized is the most common question regarding revenue recognition. Given the shift from risks and rewards to control, step 5 of the new revenue recognition model may result in an answer that varies from the outcome under legacy U.S. GAAP. In addition, in most transactions, the guidance under legacy U.S. GAAP focuses on the correct recognition point by reference to achieving the SEC's four criteria highlighted above (unless other, industry-specific guidance applies). Those four criteria are evaluated simultaneously; as a result, the four criteria act as a "gate" barring revenue recognition until all four criteria are met. Thus, much of the focus under legacy U.S. GAAP is an evaluation of each of those four criteria — when an entity can satisfactorily conclude that each of the criteria are met, that point in time becomes the recognition point for revenue purposes. This model works reasonably well in circumstances in which an entity sells a good; however, it is more challenging to apply when an entity provides a service to a customer.

While step 5 of the new revenue model similarly acts as a gate and responds to the question of "when to recognize," it is preceded by the earlier steps (i.e., steps 1–4). The conclusions reached in the earlier steps are critical to the determination of how much revenue to recognize in step 5 when control of a good or service is transferred to a customer. Therefore, whereas the guidance under legacy U.S. GAAP requires entities to evaluate the four criteria in SAB Topic 13 simultaneously, the new revenue standard generally requires a sequential evaluation of each of the four steps preceding step 5.

Given the legacy approach of assessing all four criteria in SAB Topic 13 simultaneously, some may incorrectly think that they can similarly determine when to recognize revenue under the new guidance by jumping quickly to step 5. However, it is important to realize that the new guidance requires a shift in mind-set since there is no longer a single list of criteria that must be met for revenue to be recognized. Rather, the new guidance requires entities to perform several steps methodically before recognizing revenue in step 5.

Changing Lanes — From Risks and Rewards to Transfer of Control

While the new revenue standard shifts from a risks-and-rewards-based approach to a control-based approach for determining whether and, if so, when a good or service has been transferred to a customer, the FASB and IASB did not define "good or service." Instead, the boards focused on the concept of control to determine *when* the good or service is transferred. The boards decided that assessing the transfer of control would result in more consistent decisions about when goods or services are transferred than the risks-and-rewards approach, which requires an entity to use more judgment when it retains risks and rewards to some extent. For example, the boards considered contracts in which the entity sells a product but also provides a warranty. During the development of the final standard, this example was used to challenge the risks-and-rewards model since some argue that in many such cases, the risks and rewards of the product may not have been entirely transferred to the customer given that the entity retains some risks associated with the product through the related warranty. However, it was the boards' expectation that under a control-based model, the accounting would more appropriately align recognition with performance — that is, in the fact pattern above, the entity performs by delivering a product and then, if the warranty is determined to be a service-type warranty (see Section 5.5), will recognize performance under its separate promise of a warranty over the period covered.

The new standard requires an entity first to determine, at contract inception, whether *control* of a good or service is *transferred over time*; if so, the entity would recognize the related revenue over time in a manner consistent with the transfer of the good or service over time to the customer. This method is similar to the percentage-of-completion and proportional-performance methods in current practice. If the entity cannot conclude that control is transferred over time (i.e., the transfer does not meet one of three criteria described in Section 8.4 below), control is considered to be transferred at a point in time. As a result, the entity must determine at what specific point in time to recognize the related revenue. As discussed in Section 8.6, the guidance provides five indicators to help an entity assess when that point in time is for a promised good or service. Even though the new revenue standard shifts away from risks and rewards, the boards noted that an entity could still look to whether risks and rewards have been transferred to the customer as an indicator that control has passed to the customer.

8.1.2 Performance Obligations Satisfied Over Time or at a Point in Time

ASC 606-10

25-24 For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

One of the key objectives of the FASB and IASB in establishing the new revenue standard was to create a single framework for entities to apply across disparate jurisdictions, industries, and transactions. However, there had been a long-standing view that some promises to a customer are satisfied in an exchange transaction at a point in time (generally, the transfer of a good), whereas other promises to a customer are satisfied over time as the entity performs various actions (generally, the transfer of a service). When developing the control-based model, the boards thought that using control as the basis for recognition allowed them to achieve that single model since control of something could transfer (1) at a single point in time after the completion of the entity's efforts or (2) over time in conjunction with the entity's efforts toward providing a benefit to the customer, typically through the delivery of a service.

Historically, revenue guidance has recognized the need to use models for goods that differ from those used for services. As a result, current U.S. GAAP and IFRSs include guidance that make a distinction between goods and services, for example:

- *Services* — Under current U.S. GAAP, the guidance in ASC 605-35 (formerly SOP 81-1) is applied to production and construction contracts; and under current IFRSs, the guidance in IAS 11 is applied to similar contracts. In addition, other industry-specific guidance under current U.S. GAAP can be applied in some circumstances. Further, practitioners have sometimes looked to the FASB's October 23, 1978, invitation to comment, *Accounting for Certain Service Transactions*, on applying the specific performance method, the proportional performance method, the completed performance method, or the collection method to some service transactions.
- *Goods* — Under current U.S. GAAP, entities typically apply SAB Topic 13 and the fundamentals of FASB Concepts Statement 5 to the sale of goods; and under current IFRSs, those sales are evaluated under IAS 18.

In light of this, during the development of the new revenue standard, the boards understood, and stakeholders continued to provide feedback on, the need to outline how the single model of control would be applied to the transfer of goods as compared with the transfer of services.

Thinking It Through — Two Separate Models or a Single Framework

Current guidance does not provide a single framework for revenue recognition, nor does it provide specific and separate guidance on revenue recognition related to the sale of goods and the delivery of services. Despite existing SEC and AICPA guidance and the ability to qualify for revenue recognition over time, as well as specific guidance on the sale of goods, there is no comprehensive model in current practice for determining when to recognize revenue. Therefore, while a revenue conclusion may be straightforward when the transaction is clearly within the scope of industry-specific guidance, it is often challenging to determine which guidance to apply given the "more than 100 standards on revenue and gain recognition in [current] U.S. GAAP."[1] In addition, since the various accounting literature currently in use was created over many years by different standard-setting bodies (e.g., the AICPA, EITF, and FASB),

[1] Quoted from the FASB's 2008 discussion paper on the Board's preliminary views on revenue recognition in contracts with customers.

different accounting outcomes may occur if an entity applies one piece of guidance as opposed to another. These different outcomes were the core reason for the boards' joint project on revenue and their creation of a single framework. Recognizing that new transactions emerge as companies and industries evolve, the boards realized that without a single comprehensive framework, standard setting would continue to lag and potentially create diversity in practice.

8.1.3 Defining the Terms "Goods" and "Services"

In developing the new revenue standard, the FASB and IASB considered defining a "good" and a "service" and then developing a separate revenue recognition model for each, which may have been more consistent with existing U.S. GAAP and IFRSs. Existing U.S. guidance applies a general model for most sales of goods (SAB Topic 13) and a separate model for some services (ASC 605-35, formerly SOP 81-1). Similarly, current IFRS guidance includes IAS 18 (limited guidance covering most goods and some services) and IAS 11 (covering construction contracts). However, clearly defining "good" and "service" was not as straightforward as it may have seemed, and establishing two separate frameworks did not align with the original goal of creating a new single revenue recognition framework to be applied across all transactions. Consequently, the boards continued to develop a single, control-based model.

Despite intending to create a single framework, the boards acknowledged (in a manner similar to current GAAP) that there are clear differences between the most common instances of sales of goods and delivery of services. However, along a spectrum of revenue transactions, there are instances of arrangements (e.g., construction-type contracts) in which it becomes less clear whether the entity is providing a good or a service because constructing an asset has attributes of both the sale of a good (the final constructed asset) and the delivery of a service (benefits are being provided throughout the development of the asset).

Therefore, the boards committed to developing a control-based model and determined that it would be most appropriate to describe performance obligations as being transferred either over time (most commonly in the case of services) or at a point in time (most commonly in the case of products or goods).

During the development of the new revenue standard, stakeholders questioned whether a control-based model could be applied to service contracts given that it can be difficult to identify the asset that is being provided to the customer in a service contract. Such difficulty arises because the asset is often simultaneously created and consumed by the customer, especially in the case of a pure service contract (e.g., cleaning service). As a result, stakeholders expressed concerns about whether a single control-based model could be applied to all types of contracts with customers. The boards clarified that although certain service contracts may not result in the creation of a tangible good or work in process, there is an inherent asset being created in all service contracts (i.e., the customer receives a future economic benefit as a result of the entity's performance in a service contract). In light of this, the boards decided that a separate model should not be created for service contracts and continued to develop a single control-based model.

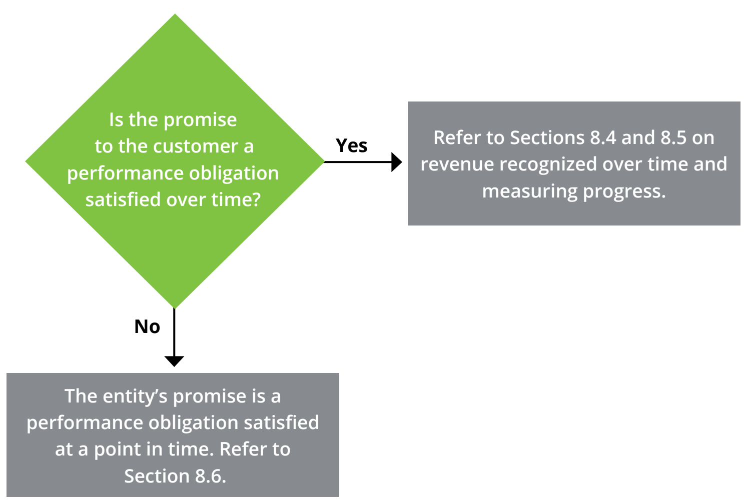
Ultimately, the boards achieved their objective of creating a single framework for revenue recognition based on control (specifically, when the **customer** obtains control of an asset) while still allowing for the disparate needs of goods and services.

See further discussion in Sections 8.4, 8.5, and 8.6 below of performance obligations satisfied over time and at a point in time.

Also, the boards determined that it was most operational to make the distinction between a performance obligation satisfied at a point in time and a performance obligation satisfied over time by using a single starting point — namely, the determination of whether the promise is a performance obligation satisfied over time, as discussed in Sections 8.4 and 8.5 below. That assessment is based on whether the performance obligation meets one of three specific criteria for recognizing revenue over time. If the promise does not meet any of the three criteria, it is, by default, a performance obligation satisfied at a point in time, as discussed in Section 8.6 below.

It is important to note that the assessment of whether a performance obligation meets the criteria for recognizing revenue over time must be performed at contract inception. In addition, the assessment of whether revenue should be recognized over time or at a point in time should be performed at the individual performance obligation level rather than at the overall contract level. Accordingly, it is important to appropriately identify the performance obligations in step 2 (refer to Chapter 5) before evaluating whether revenue should be recognized over time or at a point in time.

The following simple flowchart illustrates the process that entities should use to determine the appropriate pattern of revenue recognition:



8.2 Control

ASC 606-10

25-23 An entity shall recognize revenue when (or as) the entity satisfies a performance obligation 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 of that asset.

ASC 606-10

25-25 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

a. Using the asset to produce goods or provide services (including public services)
b. Using the asset to enhance the value of other assets
c. Using the asset to settle liabilities or reduce expenses
d. Selling or exchanging the asset
e. Pledging the asset to secure a loan
f. Holding the asset.

ASC 606 applies a single model (based on control) to all revenue transactions to determine when revenue should be recognized. ASC 606-10-25-25 defines control of an asset as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." This definition consists of three components:

- *The "ability"* — To recognize revenue, the customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset. That is, the entity should not recognize revenue until the customer has in fact obtained that right.
- *"[T]o direct the use of . . . the asset"* — This means that the customer can (1) use the asset in its own activities, (2) allow the asset to be used in another entity's activities, or (3) restrict another entity from using the asset.
- *"[A]nd obtain substantially all of the remaining benefits [from the] asset"* — To obtain control, the customer must be able to obtain substantially all of the remaining benefits from the asset (e.g., by using, consuming, disposing of, selling, exchanging, pledging, or holding the asset).

Transfer of control can be assessed from both the customer's and the seller's perspective; however, the FASB and IASB decided that control should be viewed from the **customer's perspective**. While the timing of revenue recognition could often be the same from both perspectives (i.e., when the seller surrenders control and when the customer obtains control), assessing the transfer of control from the customer's perspective minimizes the risk of recognizing revenue for activities that do not align with the transfer of the goods or services to the customer.

The notion of control is a relatively simple concept when applied to the transfer of control of a good to the customer; however, for performance obligations related to services and construction-type contracts, the notion of control may be less straightforward. For example, in arrangements in which the customer simultaneously consumes the asset as the asset is created, the customer never recognizes an asset; consequently, it may be more difficult to determine when the customer obtains control.

In developing the standard, the boards received feedback that there should be separate control guidance for goods and services; however, as discussed above, the boards ultimately decided against this because (1) it may sometimes be difficult to clearly define a service and (2) not all service contracts result in the transfer of resources to customers over time. Rather, the boards focused on the attribute of the timing of when a performance obligation is satisfied to determine whether control has been transferred. This is discussed further in Section 8.3.

Thinking It Through — Overall Shift Toward a Control-Based Model

The switch from a risks-and-rewards model to a control-based model is consistent with the FASB's overall shift in recent years toward a control-based model in other projects (e.g., consolidation, leases, and derecognition of financial assets). While the notion of control may be defined slightly differently to take into account the specifics in each of these standards, the same general concept of a control-based standard remains.

Changing Lanes — Revenue Recognition Patterns

With a shift from a risk-and-rewards approach to a control-based model, revenue recognition patterns may differ from those previously recorded. As illustrated in Section 8.1.3, a performance obligation satisfied at a point in time is generally a product or good, and a performance obligation satisfied over time is generally a service. However, certain exceptions apply, and it is important not to automatically assume that revenue from a product or good is recognized at a point in time and revenue from a service is recognized over time. For example, revenue from certain deliverables of what many may commonly consider to be goods (e.g., some contract manufacturing) may be recognized over time as revenue from a manufacturing "service." Depending on the payment terms, this may be the case when the goods being manufactured are highly customized and do not have an alternative use to the entity, thereby implying that the customer is receiving a benefit over the manufacturing period, as opposed to only when the finished goods are provided to the customer. Alternatively, revenue from certain deliverables of "services" (e.g., under some construction contracts) may need to be recognized at a point in time (in a manner similar to a completed-contract method, as described in ASC 605-35) if it is determined that the customer does not control the constructed asset until the end of the construction process. Refer to Q&As 8-1 and 8-2 below for illustrations of these concepts.

8.3 Two Models for Revenue Recognition — Based on Control

At contract inception, an entity must determine whether the performance obligation meets the criteria for revenue to be recognized over time (see Sections 8.4 and 8.5); if the performance obligation does not meet the criteria, revenue must be recognized at a point in time (see Section 8.6). That is, the entity must carefully evaluate how and when control is transferred to the customer. While generally speaking, goods are transferred at a point in time and services are transferred over time, this is not the case in all circumstances.

The Q&As below illustrate how an entity must carefully assess the terms of the arrangement and not just assess whether it is providing a good or a service to properly determine when control is transferred to the customer.

Q&A 8-1 When to Apply Point-in-Time Recognition for Goods (e.g., Contract Manufacturing)

Question

Should entities that are delivering goods (e.g., contract manufacturers and other customer manufacturing arrangements) recognize revenue over time or at a particular point in time?

Answer

It depends. Entities should carefully analyze the contractual arrangement in accordance with the three criteria in ASC 606-10-25-27 to determine whether the promise in the contract to construct and transfer goods to the customer is a performance obligation that will be satisfied over time or at a point in time.

If an entity's obligation to produce a customized product meets one of the criteria in ASC 606-10-25-27 for revenue recognition over time (e.g., the entity's performance does not create an asset with an alternative use, and the entity has an enforceable right to payment for performance completed to date), revenue related to that product would be recognized as the product is *produced*, not when the product is *delivered* to the customer.

For example, an entity that has a contract with an original equipment manufacturer (OEM) to produce a customized part for the OEM's product would meet the criteria for revenue recognition over time if the customized part has no alternative use other than as a part for the OEM's product and the entity has an enforceable right to payment for performance completed to date "at all times throughout the duration of the contract." ASC 606-10-25-28 and 25-29 as well as ASC 606-10-55-8 through 55-15 provide detailed guidance on whether an asset has an alternative use to the entity and whether an entity has an enforceable right to payment for performance completed to date. An entity would need to carefully analyze the contractual arrangements and the specific facts and circumstances to determine whether those criteria are met.

If it concludes that revenue should be recognized over time, the entity would then be required to select a method of recognizing revenue over time that most faithfully depicts the entity's performance to date for producing the product. Therefore, contract revenue should be recognized as revenue when the entity performs (i.e., the products are produced) rather than when the products are delivered to the customer.

Q&A 8-2 When to Apply Recognition Over Time to Services (e.g., Construction)

Question

Can entities that provide a service (e.g., a construction contract) assume that they meet the criteria to recognize revenue over time?

Answer

No, entities cannot assume that they can recognize revenue over time. Rather, they need to assess whether the criteria outlined in ASC 606-10-25-27 are met.

Specifically, ASC 606-10-25-27 requires one of the following criteria to be met for revenue to be recognized over time:

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.

The assessment should be made at contract inception. If a contract does not meet any of the criteria in ASC 606-10-25-27, the entity should recognize revenue at a point in time rather than over time.

The entity should carefully analyze the terms of the contractual arrangement(s) in accordance with the requirements in ASC 606-10-25-27 to determine whether the performance obligation is satisfied over time or at a particular point in time.

Accordingly, entities that had recognized revenue over time under ASC 605-35 or other revenue guidance should not assume that they will continue to be able to do so under ASC 606.

The criteria in ASC 606-10-25-27 are discussed in further detail in Section 8.4.

Q&A 8-3 Whether an Entity Is Free to Choose Whether to Recognize Revenue Over Time or at a Point in Time

Question

Is the decision to recognize revenue over time or at a point in time a free choice?

Answer

No. At contract inception, an entity must carefully evaluate whether the performance obligation meets any of the three criteria in ASC 606-10-25-27 for revenue recognition over time. If one or more of the criteria are met, the performance obligation must be recognized over time. However, if none of the criteria are met, the entity should recognize revenue at a point in time.

Accordingly, it would not be appropriate to recognize revenue at a point in time if one of the three criteria in ASC 606-10-15-27 is met.

Thinking It Through — Step-by-Step Approach

When entities think about revenue recognition, it may seem natural or logical to jump directly to determining when revenue can be recognized in step 5. However, understanding the nature of the arrangement in step 1 and the identity of the promised goods or services in step 2 is critical to determining when transfer of control occurs in step 5. As discussed in Section 8.1.3, applying the steps sequentially is important because the assessment of whether revenue should be recognized over time or at a point in time should be performed at the individual performance obligation level rather than at the overall contract level.

For example, suppose that an entity sells a product with a multiyear warranty to a customer. Without identifying and assessing the nature of the promised goods and services in the contract, the entity may incorrectly assume that it should recognize all of the revenue when the product is transferred to the customer. However, upon assessing the nature of the promised goods and services in the contract, the entity determines that the multiyear warranty represents a service-type warranty (rather than an assurance-type warranty). In this situation, the contract would include two performance obligations: (1) the product and (2) the service-type warranty. In accordance with step 4 (see Chapter 7) revenue should be allocated to the product and the service-type warranty. The revenue allocated to the product would be recognized at the point in time when control is transferred (see Section 8.6), and the revenue allocated to the service-type warranty should be recognized over the multiyear warranty period (see Sections 8.4 and 8.5). See Chapter 5 for additional information on determining whether a warranty represents a distinct service in the contract.

Driving Discussion — Assessing the Nature of the Promise

Identifying the nature of the arrangement and the identity of the promised goods or services may be challenging in many instances, such as in certain types of stand-ready obligations or when an entity is acting as an agent. For example, in an arrangement in which a price comparison Web site (the entity) allows its users (customers) to select services from a wide range of providers (e.g., hotels, airlines) and make purchases through the site, stakeholders have questioned whether revenue should be recognized before the user executes a purchase (e.g., selects and books a hotel room or flight). That is, when an entity acts as an agent, it could be thought of as providing a service throughout a certain period of effort, or it could instead be viewed as performing a single act of matching the buyer with a provider (when the agent finds a buyer). The entity earns a commission for acting as a broker; however, the entity is also providing a service of price comparisons and in essence is creating a lead for the provider. Stakeholders have therefore questioned whether revenue should be recognized before the customer makes a purchase through the site since some views indicate that value is being transferred to the user before the execution of a purchase through the site. In light of this, the entity should first assess the nature of its promise in the contract to understand whether its promise is fulfilled at a point in time or over time so that it can appropriately recognize revenue. For additional discussion, see Section 8.9.4.

8.4 Revenue Recognized Over Time

ASC 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:

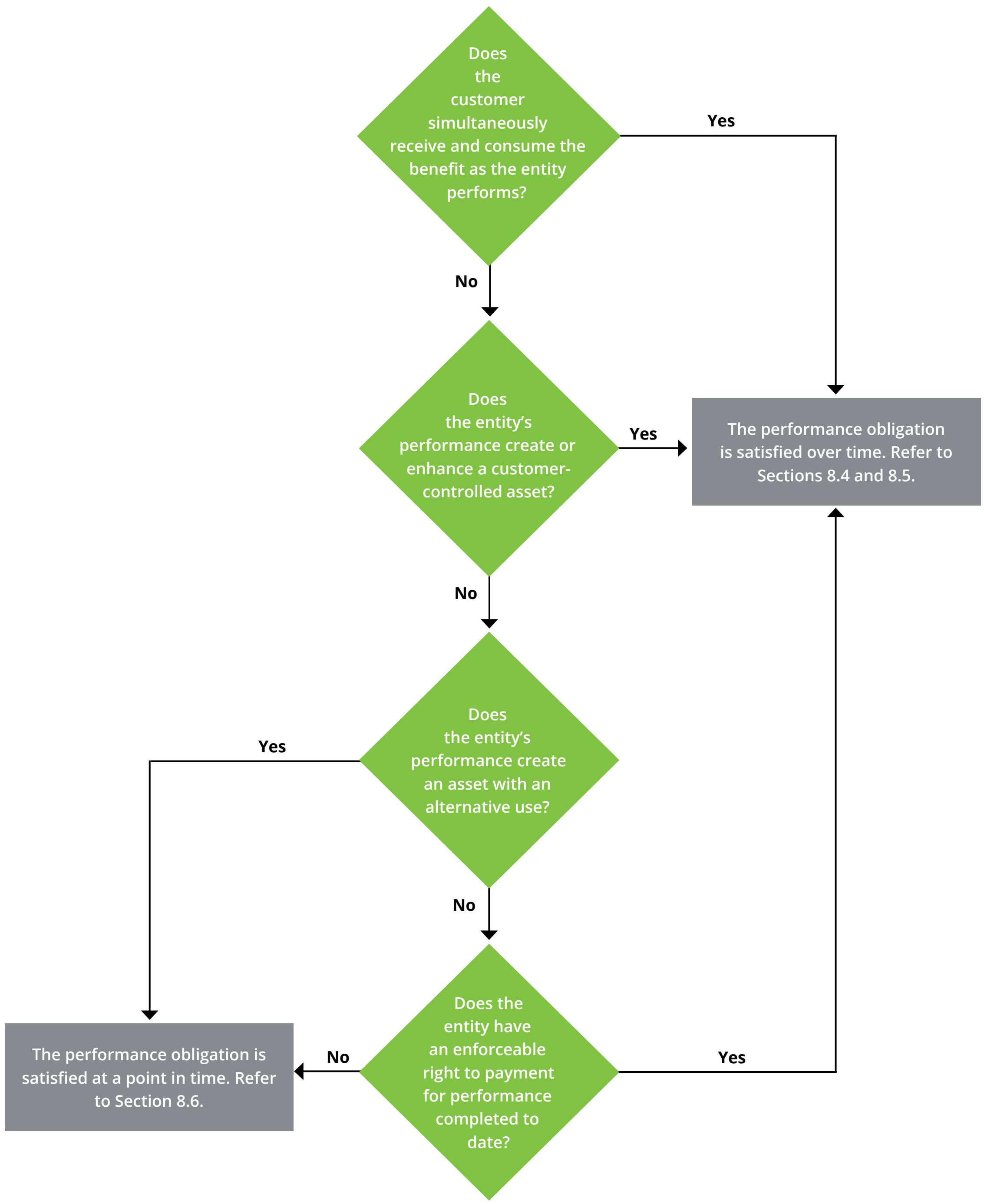
a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).

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).

ASC 606-10-25-27 is one of the most critical paragraphs in the standard since it effectively defines whether the entity is (1) providing the customer with a service (and revenue can be recognized as the entity is performing) or (2) providing the customer with a good (and revenue can only be recognized when the entity finishes what it was asked to do and the good is transferred/delivered to the customer).

The criteria in ASC 606-10-25-27 were developed to provide an objective basis for assessing whether control is transferred over time and, therefore, the performance obligation is satisfied over time. The following flowchart summarizes the criteria in ASC 606-10-25-27 (which are discussed in further detail in Sections 8.4.1, 8.4.2, and 8.4.3):



Q&A 8-4 Meeting More Than One of the Criteria for Recognition of Revenue Over Time

Question

Is it possible for an entity to satisfy more than one of the criteria in ASC 606-10-25-27?

Answer

Yes. The criteria in ASC 606-10-25-27 are not intended to be mutually exclusive, and it is possible that an entity will meet more than one criterion. For example, in some cases it may be determined that the "entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced" (ASC 606-10-25-27(b)) and that the entity also "does not create an asset with an alternative use to the entity [and] has an enforceable right to payment for performance completed to date" (ASC 606-10-25-27(c)).

When one or more of the criteria in ASC 606-10-25-27 are met, revenue should be recognized over time.

Q&A 8-5 Application of ASC 606-10-25-27 to Contracts With a Very Short Duration

Question

For contracts with a short duration (e.g., a one-year contract or a one-month contract), does ASC 606 contain any practical expedient under which entities would not be required to assess whether revenue should be recognized over time or at a point in time but rather would simply default to point-in-time recognition?

Answer

No. ASC 606 does not contain any such practical expedient. Entities should carefully analyze the contractual arrangement in accordance with the requirements of ASC 606-10-25-27 to determine whether the performance obligation is satisfied over time or at a point in time, even for short-duration contracts.

8.4.1 Simultaneous Receipt and Consumption of Benefits of the Entity's Performance

ASC 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. [Omitted]
c. [Omitted]

ASC 606-10

55-5 For some types of performance obligations, the assessment of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

55-6 For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer. In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity should make both of the following assumptions:

a. Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity
b. Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

The first criterion for determining whether a performance obligation is satisfied over time (ASC 606-10-25-27(a)) is that a customer simultaneously receives and consumes benefits as the entity performs. This criterion most commonly applies to typical service contracts, which would generally meet the criterion. That is, the entity's performance momentarily creates an asset that the customer simultaneously receives and consumes, which means that the customer obtains control of the entity's output as the entity performs. Typically, in contracts that meet the criterion in ASC 606-10-25-27(a), there is no tangible asset that is being created by the accumulation of effort of the entity as it performs. For example, a contract to provide a cleaning service and a contract to process transactions on behalf of a customer are arrangements in which the customer simultaneously consumes as the entity performs. That is, in each of those examples, there is no accumulation of the entity's efforts to build or create a tangible asset (e.g., a report, completed building, or piece of specialized equipment). However, the customer does benefit from the entity's efforts as the entity performs; therefore, control of an asset is transferred to the customer over time.

The FASB and IASB observed that determining whether the customer simultaneously receives and consumes may be difficult in service-type contracts because the notion of "benefit" can be subjective. Paragraph BC126 of ASU 2014-09 provides a shipping example in which an entity has agreed to transport goods from Vancouver to New York City. Stakeholders questioned whether the customer in that example receives any benefit as the goods are transported. ASC 606-10-55-6 notes that an entity's customer receives benefit as the entity performs if another entity would not need to substantially reperform the work that the entity has completed to date to fulfill the remaining performance obligation.

ASC 606-10-55-6(b) clarifies that when assessing whether another entity would not need to substantially reperform the work completed to date, an entity should presume that the other entity would not be able to use the asset being used by the current entity to fulfill the performance obligation. The boards observed that if the goods in the shipping example described above were to be transported only part of the way (e.g., to Chicago), another entity would not need to substantially reperform what has already been performed even though that other entity does not have the benefit of using the original entity's truck to transport the goods. Therefore, even though the new entity would need to use its own truck to complete the fulfillment of the performance obligation, the customer does in fact benefit from the original entity's performance as the work is performed (i.e., transfer of the goods from Vancouver to Chicago). Consequently, the boards observed that assessing whether another entity would need to substantially reperform the performance completed to date can be a good indicator of whether the customer benefits simultaneously as the entity performs. However, the boards also decided that in making this assessment, an entity should disregard any contractual or practical limitations since the objective of the criterion in ASC 606-10-25-27(a) is to determine whether control of the goods or services has already been transferred to the customer. That is, the entity would need to hypothetically assess what another entity would need to perform if the original entity were to stop performance and let the second entity take over, regardless of actual practical or contractual limitations. This hypothetical assessment would only be applicable when the customer simultaneously receives and consumes as the entity performs; such an assessment would not be appropriate for scenarios that meet either of the other two criteria in ASC 606-10-25-27, which are discussed further below.

ASC 606-10

Example 13 — Customer Simultaneously Receives and Consumes the Benefits

55-159 An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

55-160 The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 606-10-25-14(b). The performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to reperform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

TRG Update — Determining When Control of a Commodity Is Transferred

Stakeholders have raised questions regarding the determination of when an entity transfers control of a commodity. Specifically, they have questioned whether revenue related to the delivery of a commodity should be recognized (1) at a point in time for each commodity delivery or (2) over time because the entity is providing a commodity delivery service of which the customer simultaneously receives and consumes the benefits. In particular, the analysis in question has focused on ASC 606-10-25-27(a), one of the three criteria for determining whether revenue should be recognized over time.

For the criterion in ASC 606-10-25-27(a) to be met, the customer must simultaneously receive and consume the benefits of the good or service (e.g., the commodity) as the entity performs. At the TRG's July 2015 meeting, TRG members discussed the evaluation of the criterion in ASC 606-10-25-27(a) and generally agreed that an entity should consider "all relevant facts and circumstances, including the inherent characteristics of the commodity, the contract terms, and information about infrastructure or other delivery mechanisms."[2] TRG members also generally agreed with performing the evaluation in this manner "regardless of whether the contract is for the delivery of a commodity or a widget."[3]

[2] Quoted from TRG Agenda Paper 43.
[3] See footnote 2.

Accounting outcomes may differ if a multiperiod commodity supply contract is viewed as individually distinct goods or services (i.e., each individual delivery is a performance obligation satisfied at a point in time) or as a series of distinct goods or services of which the customer simultaneously receives and consumes the benefits (i.e., delivery is part of a single performance obligation satisfied over time). If the contract is determined to be for the delivery of individually distinct goods or services (that do not qualify to be accounted for as a series), the entity would need to allocate the transaction price to each distinct good or service on a relative selling price basis. If the goods or services in the contract are determined to be a series (i.e., a single performance obligation satisfied over time), the entity would need to identify a single measure of progress to determine the pattern of revenue recognition.

Driving Discussion — Customer Action to Immediately Receive and Consume a Commodity or Use It Later

An entity may need to evaluate whether the customer's action or intent to immediately receive and consume a commodity or use the commodity later will affect whether the entity is able to conclude that it meets the criteria for recognizing revenue over time (i.e., by meeting the criterion that the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs). Customers in certain industries (e.g., oil and gas, power and utilities) may take different actions or have different intents for the commodity delivered by the entity.

For example, a gas utility customer of an entity that explores for and produces natural gas may store natural gas in a pool until demand from its own customers requires the natural gas to be used. Conversely, those same customers of the gas utility may not have infrastructure with which to store natural gas in their homes and thereby immediately receive and consume any natural gas delivered by the utility (e.g., to heat a stove).

An entity will need to carefully evaluate "all relevant facts and circumstances, including the inherent characteristics of the commodity, the contract terms, and information about infrastructure or other delivery mechanisms,"[4] to determine whether the criterion in ASC 606-10-25-27(a) for recognizing revenue over time is met.

8.4.2 Customer Controls the Asset as It Is Created or Enhanced

ASC 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. [Omitted]
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. [Omitted]

[4] See footnote 2.

ASC 606-10

55-7 In determining whether a customer controls an asset as it is created or enhanced in accordance with paragraph 606-10-25-27(b), an entity should apply the guidance on control in paragraphs 606-10-25-23 through 25-26 and 606-10-25-30. The asset that is being created or enhanced (for example, a work in process asset) could be either tangible or intangible.

The second criterion for determining whether a performance obligation is satisfied over time (ASC 606-10-25-27(b)) is that the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. This criterion was intended to address situations in which the entity is creating an asset but it is clear that the customer controls the work in process as the asset is created. Arrangements that would meet this criterion for recognizing revenue over time include, but are not limited to, (1) a renovation of, or addition to, the customer's existing property and (2) the integration of computer hardware at the customer's location. Because the customer controls the work in process, the customer is benefiting from the entity's performance as the entity performs.

The basis for this criterion is consistent with the rationale for using the percentage of completion method for revenue recognition under existing U.S. GAAP, which acknowledges that in many construction contracts, the entity has in effect agreed to sell its right to the asset as it performs (i.e., it is selling the work in process to the customer as it performs).

However, in some instances, it may be unclear whether the asset being created or enhanced is controlled by the customer, thus making it more difficult to determine whether this criterion is met. Therefore, the boards developed the third criterion.

8.4.3 Entity's Performance Does Not Create an Asset With an Alternative Use, and the Entity Has an Enforceable Right to Payment

ASC 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. [Omitted].
b. [Omitted].
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).

The third criterion (ASC 606-10-25-27(c)) was developed because the FASB and IASB observed that applying the first two criteria could sometimes be challenging. In addition, the boards believed that there are other scenarios economically similar to those described in ASC 606-10-25-27(a) and (b) in which an entity's performance is more akin to a service than the completion and delivery of a good. Paragraph BC132 of ASU 2014-09 states that the boards regarded the third criterion as potentially necessary not only "for services that may be specific to a customer (for example, consulting services that ultimately result in a professional opinion for the customer) but also for the creation of tangible (or intangible) goods."

The boards believed that there are two mandatory features of arrangements that meet this criterion. As a result, this criterion involves a two-part assessment (i.e., to meet the criterion, an entity must demonstrate compliance with two subcriteria), which includes two notions: "alternative use" and "right to payment."

8.4.3.1 Alternative Use

ASC 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.

ASC 606-10

55-8 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

55-9 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

55-10 A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

The notion of alternative use was developed to distinguish circumstances in which the entity's performance does not represent a service and therefore would not result in the transfer of control to the customer over time. That is, if the asset has an alternative use, the asset could easily be redirected to another customer, which is commonly the case for standard inventory-type items. In the case of inventory (readily redirected assets), the production effort is not transferring a benefit to the customer as the entity performs. The criterion in ASC 606-10-25-27(c) was intended to apply to circumstances in which the entity creates a highly customized or specialized asset that would be difficult to redirect to another customer without incurring significant costs and performing additional reconfiguration.

In making this assessment, the entity needs to consider both practical limitations and contractual restrictions on redirecting the asset for another use. For example, if the terms of the contract indicate that the entity is prohibited from transferring the asset to another customer and that restriction is substantive, the entity would conclude that the asset does not have an alternative use because the entity is contractually prohibited from redirecting the asset for another use. This is often the case in real estate contracts; however, it may also occur in other types of contracts.

On the other hand, contractual restrictions that provide the customer with a protective right are not sufficient to establish that there is no alternative use for the asset. Protective rights typically allow the entity to substitute the asset, or redirect the asset, without the customer's knowledge. For example, terms of the contract may indicate that the entity cannot transfer a good because the customer has legal title to the goods in the contract; however, these terms act merely as protection in the event of liquidation, and the entity can then physically substitute the asset or redirect it to another customer for little cost. This type of contractual restriction is a protective right and would not be viewed as transferring control to the customer.

The assessment of alternative use should be performed at contract inception and should not be updated. In addition to concluding that there is no alternative use, the entity must also conclude that it has a right to payment for performance completed to date, which is further described in Section 8.4.3.2 below.

ASC 606-10

Example 15 — Asset Has No Alternative Use to the Entity

55-165 An entity enters into a contract with a customer, a government agency, to build a specialized satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

55-166 At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

55-167 As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 606-10-25-27(c), 606-10-25-28, and 606-10-55-8 through 55-10) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

55-168 For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 606-10-25-27(c) also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this Example.

8.4.3.2 Right to Payment for Performance Completed to Date

ASC 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.

ASC 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.

55-12 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

55-13 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

55-14 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

a. Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.
b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.
c. An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

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.

Right to payment is the second mandatory feature in the assessment of whether the criterion in ASC 606-10-25-27(c) is met. The boards reasoned that if an entity is creating a highly specialized or customized asset without an alternative use (i.e., the entity meets the first subcriterion in ASC 606-10-25-27(c)), the entity would want to be economically protected from the risk associated with doing so. Consequently, the boards incorporated the requirement of a right to payment into the third criterion for assessing whether the entity is transferring control of the asset to the customer over time (i.e., providing a service). In addition, the customer's obligation to pay for performance completed to date indicates that the customer has received some of the benefits of the entity's performance.

For the purpose of evaluating the guidance in ASC 606-10-25-27(c), the right to payment refers to a payment compensating the entity for performance completed to date and does not pertain to, for example, a deposit or payment to compensate the entity for inconvenience or loss of profit in the event of a termination. The right to payment for performance completed to date must include compensation for costs incurred to date plus a reasonable profit margin. A reasonable profit margin does not necessarily mean the profit margin that the entity would earn on the entire contract once completed (i.e., if the contract were to be terminated at any point in time, the partially completed asset may not be proportional to the value of the contract if it was completed). Rather, a reasonable profit margin should be (1) based on a reasonable proportion of the entity's expected profit margin or (2) a reasonable return on the entity's cost of capital.

Further, the right to payment must be an enforceable right to demand or retain payment, or both. However, it does not need to be a present unconditional right to payment in the event that the customer terminates the contract before the asset is fully completed.

If the customer pays a nonrefundable up-front fee, this could be viewed as a right to payment if the entity is able to retain an amount for performance completed to date in the event of a contract termination.

Lastly, the boards clarified that there may be instances in which an entity's customer does not have the right to terminate the contract, or only has the right to terminate the contract at specified times, but the entity may still conclude that it has an enforceable right to payment. Such instances may occur if the contract or other jurisdictional laws require completion of obligations by both the entity and the customer. This is often referred to as the specific performance notion. Refer to Q&A 8-7 for an illustration of the specific performance notion.

While an entity may conclude that it meets the criterion in ASC 606-10-25-27(c) for recognizing revenue over time because it is creating an asset that does not have an alternative use and it has the right to payment for performance completed to date, recognition of revenue may not be appropriate for materials purchased that are not yet incorporated into the asset. For example, an entity may purchase raw materials that will be used as inputs to satisfy the performance obligation, but the inputs are not yet transferred to the customer through incorporation into the asset and therefore still may be used for other purposes. The Q&A below illustrates this concept.

Q&A 8-6 Recognition of Revenue Over Time — No Enforceable Right to Payment for Goods Purchased for the Contract but Not Yet Used

Entity X enters into a contract with Customer Y under which X will construct an asset for Y that has no alternative use to X. To build this machine, X acquires standard materials that it regularly uses in other contracts and manufactures some "generic" component parts for inclusion in the customer's asset. These standard materials remain interchangeable with other items until actually deployed in the asset for Y.

If Y cancels the contract, X will be entitled to reimbursement for costs incurred for work completed to date plus a margin of 10 percent (which is considered to be a reasonable margin in accordance with ASC 606-10-55-11). However, X will not be reimbursed for any materials (e.g., subcomponent parts) that have been purchased for use in the contract but have not yet been used and are still controlled by X.

Under ASC 606-10-25-27(c), revenue from a contract should be recognized over time if 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**" (emphasis added).

Question

Does the contract with Customer Y meet the condition in ASC 606-10-25-27(c) for recognition of revenue over time?

Answer

Yes. The asset that X is constructing for Y has no alternative use to X, and the terms of the contract reimburse X for the costs of work completed to date plus a reasonable margin. However, materials (e.g., subcomponent parts that may be classified as inventory) that have not yet been used are not part of "performance completed to date"; therefore, there is no requirement that the entity have an enforceable right to reimbursement for such items.

Under the contract termination provisions, if the customer terminates the contract early, X is entitled to payment of costs incurred plus a reasonable profit margin. However, the contractual terms do not include payment for standard materials or "generic" component parts that were specifically acquired for the project but not yet incorporated into the customized machine.

That is, if the raw materials or work in process has an alternative use before being integrated into the manufacturing process, the raw materials or work in process would not be considered costs of the contract until integrated into the manufacturing process. Consequently, the materials or work in process does not transfer to the customer until (1) integration of the materials or work in process into the project and (2) the entity has an enforceable right to payment.

Therefore, the absence of a right to payment for raw materials or work in process that has an alternative use does not preclude an entity from being able to conclude that a performance obligation is satisfied over time when the entity has an enforceable right to payment for performance completed to date once the entity has integrated the raw materials or work in process into the project.

Driving Discussion — Right to Payment Guidance and Termination Provisions

An entity that has entered into a contract to manufacture customized goods may conclude that the goods have no alternative use. In addition, depending on the payment terms of the contract for customized goods, the entity may be required to recognize revenue over time. In this arrangement, the entity will need to carefully consider the contract's payment terms to determine the appropriate recognition of revenue. Specifically, the entity may need to consider termination provisions in the arrangement and how they interact with the entity's right to payment. For example, if the entity has some rights to payment for its performance, but the contract has a termination provision that allows the customer to cancel at any time with no obligation to pay the entity for work performed under the contract, the entity may not meet the criteria for recognizing revenue over time because it has not met the right to payment requirement.

ASC 606-10

Example 14 — Assessing Alternative Use and Right to Payment

55-161 An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 percent margin. The 15 percent margin approximates the profit margin that the entity earns from similar contracts.

55-162 The entity considers the criterion in paragraph 606-10-25-27(a) and the guidance in paragraphs 606-10-55-5 through 55-6 to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially reperform the work that the entity had completed to date because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 606-10-25-27(a) is not met.

55-163 However, the entity's performance obligation meets the criterion in paragraph 606-10-25-27(c) and is a performance obligation satisfied over time because of both of the following factors:

a. In accordance with paragraphs 606-10-25-28 and 606-10-55-8 through 55-10, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.
b. In accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

55-164 Consequently, the entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

ASC 606-10

Example 16 — Enforceable Right to Payment for Performance Completed to Date

55-169 An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 percent of the contract price, regular payments throughout the construction period (amounting to 50 percent of the contract price), and a final payment of 40 percent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are nonrefundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

55-170 At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

55-171 As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 606-10-25-27(c), 606-10-25-29, and 606-10-55-11 through 55-15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are nonrefundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

55-172 Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 606-10-25-27(c). Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 606-10-25-27(a) or (b), and, thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Example 17 — Assessing Whether a Performance Obligation Is Satisfied at a Point in Time or Over Time

55-173 An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A — Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date

55-174 The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

55-175 At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 606-10-25-27(c). Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

ASC 606-10 (continued)

Case B — Entity Has an Enforceable Right to Payment for Performance Completed to Date

55-176 The customer pays a nonrefundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

55-177 At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

55-178 The entity also has a right to payment for performance completed to date in accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

55-179 Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 606-10-25-27(c) are met, and the entity has a performance obligation that it satisfies over time. To recognize revenue for that performance obligation satisfied over time, the entity measures its progress toward complete satisfaction of its performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

55-180 In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract.

Case C — Entity Has an Enforceable Right to Payment for Performance Completed to Date

55-181 The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

55-182 Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph 606-10-55-13), provided that the entity's rights to require the customer to continue to perform as required under the contract (that is, pay the promised consideration) are enforceable.

Q&A 8-7 Real Estate Sales Before Completion by a Property Developer

Entity A, a real estate developer, entered into sales and purchase agreements with various buyers before the completion of a property project. The properties are located in Country B. The sales and purchase agreements include the following key terms:

- A specific unit is identified in the contract.
- Entity A is required to complete the property in all respects in compliance with the conditions set out in the sales agreement and the related building plans within two years from the time when the sales contracts are entered into.
- The property remains at A's risk until delivery.
- The buyer is not permitted at any time before delivery to sub-sell the property or transfer the benefit of the agreement. However, the buyer can at any time before the date of assignment mortgage the property to finance the acquisition of the property.
- The agreement specifies that the sales agreement can be canceled only when both the buyer and A agree to do so — in effect, the buyer does not have the right to cancel the sales agreement.
- If both the buyer and A agree to cancel the contract, A has the right to retain 10 percent of the total purchase price, and the buyer is required to pay for all necessary legal and transaction costs incurred by A in relation to the cancellation.
- If A fails to complete the development of the property within the specified two-year period, the buyer has the right to rescind the sales contract and A is required to repay to the buyer all amounts paid by the buyer together with interest. Otherwise, the buyer does not have a right to cancel the contract.
- The purchase consideration is payable as follows:
  - 5 percent of the entire sale consideration upon entering into the sales agreement.
  - 5 percent of the purchase consideration within one month from the date when the sales agreement is entered into.
  - 5 percent of the purchase consideration within three months from the date when the sales agreement is entered into.
  - The remaining 85 percent of the purchase consideration upon delivery of the property.

Note that, for simplicity, this example does not address whether there is a significant financing element.

Question

Should A recognize revenue over time or at a point in time?

Answer

Under ASC 606, an entity satisfies a performance obligation over time when it transfers control of the promised good or service over time. ASC 606-10-25-27 states that an entity transfers control of a good or service over time and, consequently, 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 . . . .
>
> 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.

Criterion (a) above is not relevant in the determination of whether revenue from real estate sales (before completion) should be recognized over time or at a point in time. This is because buyers generally do not consume all of the benefits of the property as the real estate developers construct the property; rather, those benefits are consumed in the future.

Criterion (b) above is not directly relevant either because, without further consideration of criterion (c), a conclusion cannot be reached about whether the buyers have control of the property as A develops the property. For example, property buyers do not typically obtain physical possession of the property until construction is completed.

Entity A should focus on criterion (c), and particularly on:

- Whether an asset has been created with an alternative use to the real estate developer; and
- Whether the real estate developer has an enforceable right to payment for performance completed to date.

Has an Asset Been Created With an Alternative Use to Entity A?

In accordance with ASC 606-10-25-28, an asset 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.

With regard to contract restriction, ASC 606-10-55-8 states that the entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

Since each sales contract specifies the unit to be delivered, the property unit does not have an alternative use to A. The contract precludes A from transferring the specified unit to another customer.

Does Entity A Have an Enforceable Right to Payment for Performance Completed to Date?

The payment schedule per the sales and purchase agreement does not correspond to the performance completed to date. However, in assessing whether it has the right to payment for performance completed to date, A should not only consider the payment schedule but should also consider ASC 606-10-55-13, which states:

> In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

In the circumstances under consideration, the contract specifies that the customer cannot terminate the contract unless both the property developer and the buyer agree to do so. In effect, the buyer does not have the discretion to terminate the contract as it wishes.

ASC 606-10-25-28 requires an entity to 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. If, taking into account practice and legal precedent in Country B, A has the right to continue to perform the contract and be entitled to all of the consideration as promised, even if the buyer acts to terminate the contract (as articulated in ASC 606-10-55-13 and ASC 606-10-55-88), A has the enforceable right to payment for performance completed to date.

The same response (i.e., the recognition of revenue over time) applies irrespective of whether A allows buyers to choose to pay the consideration on the basis of the agreed-upon payment schedule or to pay all of the consideration up front.

Should Entity A Recognize Revenue Over Time or at a Point in Time?

Since the asset does not have an alternative use to A, and provided that A has an enforceable right to payment for performance completed to date, it should recognize revenue over time. However, if A does not have an enforceable right to payment for the performance completed to date, it should recognize revenue at a point in time (i.e., at the point when the control of the property unit is transferred to the buyer, which would normally be at the time of delivery).

8.5 Measuring Progress for Revenue Recognized Over Time

ASC 606-10

25-31 For each performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, 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).

25-32 An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

After determining that a performance obligation is satisfied over time, an entity must determine the appropriate method for depicting that performance over time — that is, how far complete the entity's progress is as of any given reporting period. This method is described in the new revenue standard as the entity's measure of progress.

For example, if a contract requires a calendar-year reporting entity to perform a daily cleaning service for 12 months beginning on January 1, the entity may, depending on the facts and circumstances, measure progress in any of the following ways:

- *Based on days passed (i.e., time elapsed)* — For example, as of March 31, 90 days have passed, so the entity's performance is 25 percent complete.
- *Based on costs incurred* — For example, as of March 31, the entity has incurred $300,000 of the expected costs of $1 million, so the entity's performance is 30 percent complete.
- *Based on labor hours* — For example, as of March 31, the entity has incurred 260 hours of cleaning of the expected 1,100 hours for the full year. As a result, the entity's performance is 24 percent complete.

8.5.1 Methods for Measuring Progress

ASC 606-10

Methods for Measuring Progress

25-33 Appropriate methods of measuring progress include output methods and input methods. Paragraphs 606-10-55-16 through 55-21 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.

Q&A 8-8 Selecting a Measure of Progress Toward Complete Satisfaction of a Performance Obligation

When a performance obligation is satisfied over time, an entity must select a measure of progress (e.g., time elapsed, labor hours, costs incurred) to depict its progress toward complete satisfaction of that obligation.

In accordance with ASC 606-10-25-33, appropriate methods of measuring progress include:

- *Output methods* — ASC 606-10-55-17 states that 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." These methods "include surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered."
- *Input methods* — ASC 606-10-55-20 states that 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."

In discussing the selection of a measure of progress, paragraph BC164 of ASU 2014-09 states:

> The [FASB and IASB] decided that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer. However, the Boards observed that it would be appropriate for an entity to use an input method if that method would be less costly and would provide a reasonable proxy for measuring progress.

Question

Does the statement in paragraph BC164 of ASU 2014-09 mean that it is preferable for an entity to use an output method when measuring progress toward complete satisfaction of a performance obligation?

Answer

No. As stated in paragraph BC159 of ASU 2014-09, an entity does not have a free choice in selecting an appropriate method of measuring progress toward complete satisfaction of a performance obligation but should exercise judgment in identifying a method that fulfills the stated objective in ASC 606-10-25-31 of depicting an entity's performance in transferring control of goods or services promised to a customer (i.e., the satisfaction of the performance obligation).

Neither an input method nor an output method is preferred since each has benefits and disadvantages that will make it more or less appropriate to the facts and circumstances of each contract. While an output method is, as stated in paragraph BC164, conceptually preferable in a general sense, an appropriate measure of output will not always be directly observable; and sometimes, an apparent measure of output will not in fact provide an appropriate measure of an entity's performance. Information needed to apply an input method is more likely to be available to an entity without undue cost, but care should be taken to ensure that any measure of an entity's inputs used is reflective of the transfer of control of goods or services to the customer.

Considerations that may be relevant to the selection of a measure of progress include the following:

- An output method would not provide a faithful depiction of the entity's performance if the output selected fails to measure some of the goods or services transferred to the customer. For example, a units-of-delivery or a units-of-production method may sometimes understate an entity's performance by excluding work in progress that is controlled by the customer. (See paragraph BC167 of ASU 2014-09.)
- An input method may better reflect progress toward complete satisfaction of a performance obligation over time when (1) the performance obligation consists of a series of distinct goods or services that meets the criteria in ASC 606-10-25-14(b) to be treated as a single performance obligation and (2) the effort required to create and deliver the first units is greater than the effort to create the subsequent units because of the effect of a "learning curve" of efficiencies realized over time. (See paragraph BC314 of ASU 2014-09.)
- An entity applying an input method must exclude from its measure of progress the costs incurred that (1) do not contribute to the entity's progress in satisfying a performance obligation (e.g., the costs of unexpected amounts of wasted materials) and (2) are not proportionate to the entity's progress in satisfying the performance obligation (e.g., the cost of obtaining goods from a vendor that accounts for most of the product's cost). (See ASC 606-10-55-21.)

TRG Update — Evaluating How Control Transfers Over Time

As discussed above, if the entity meets one of the three criteria in ASC 606-10-25-27, it recognizes revenue over time by using either an output method or an input method to measure its progress toward complete satisfaction of the performance obligation. While the new revenue standard does not prescribe which method to use, the entity should select an approach that faithfully depicts its performance in transferring control of goods or services promised to a customer.

At the TRG's April 2016 meeting, the TRG discussed two views articulated by stakeholders on whether an entity that is performing over time can transfer control of a good or service underlying a performance obligation at discrete points in time:

- *View A* — Satisfaction of any of the requirements for recognition over time implies that control does not transfer at discrete points in time. Therefore, an entity's use of an appropriate measure of progress should not result in its recognition of a material asset (e.g., work in progress) for performance the entity has completed. Proponents of View A point to paragraphs BC125, BC128, BC130, BC131, BC135, and BC142 of ASU 2014-09, which clarify that control of any asset (such as work in progress) transfers to the customer as progress is made.
- *View B* — Satisfaction of any of the criteria for recognition over time does not preclude transfer of control at discrete points in time. The use of an appropriate measure of progress could therefore result in the recognition of a material asset for performance under a contract. Proponents of View B emphasized that ASC 606-10-25-27(c) specifically "contemplates transfer of control at discrete points in time." They also noted that the term "could" in paragraph BC135 of ASU 2014-09 implies that in certain circumstances, the customer may not control the asset as performance occurs. In addition, proponents of View B indicated that "if control can never transfer at discrete points in time, certain methods of progress referenced in the new revenue standard [e.g., milestones[5]] rarely would be permissible."[6]

[5] Footnote 1 in TRG Agenda Paper 53 notes that as used in the discussion, "milestones" refer to measures of progress (i.e., they correlate to an entity's performance toward complete satisfaction of a performance obligation) rather than the "milestone method" under existing U.S. GAAP.

[6] Quoted from paragraph 19 of TRG Agenda Paper 53.

The FASB staff believes that View B is inconsistent with the new revenue standard but that View A is appropriate. The staff reiterated that paragraphs BC125, BC128, BC130, BC131, BC135, and BC142 of ASU 2014-09 clarify that when an entity satisfies any of the three criteria for recognizing revenue over time, the entity's performance is an asset that the customer controls. The staff also indicated that under paragraph BC135, an entity would consider whether it has a right to payment in determining whether the customer controls an asset. Therefore, in the staff's view, 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)."[7]

The FASB staff also noted that (1) View A does not prohibit an entity from recognizing revenue over time if there is a period during which the entity does not perform any activities toward satisfying its performance obligation (i.e., if there is a break in the period of performance) and (2) although Example 27 in the new revenue standard refers to milestone payments, the standard does not conclude that milestones are the appropriate measure of progress. Therefore, entities must use judgment in selecting an appropriate measure of progress.

TRG members generally agreed with the FASB staff's view that the satisfaction of any of the requirements for revenue recognition over time implies that control does not transfer to the customer at discrete points in time. Consequently, an entity should not record material work in process that is associated with a performance obligation that is satisfied over time.

Certain TRG members questioned the FASB staff's view that there could be times when an entity may recognize an immaterial asset (e.g., work in progress) under a recognition-over-time model because the entity's selected measure of progress may not perfectly match its performance. Specifically, they cited ASC 340-40-25-8, which requires an entity to recognize costs related to satisfied and partially satisfied performance obligations as expenses when they are incurred.

TRG members indicated that an asset could result from activities that are not specific to the customer contract (i.e., the creation of general inventory). They reiterated the importance of understanding the differences between costs associated with the development of an asset that transfers to a customer as it is created and costs to develop assets for general inventory (i.e., before the asset undergoes modifications that are specific to the customer). One TRG member discussed an example that involved large, complex, and customized assets. He noted that activities can be performed to assemble parts, for example, and that such costs may represent inventory (and thus an asset) because the assets are interchangeable for use in more than one customer contract.

However, provided that the entity has a present right to payment, revenue recognition would begin (and the inventory would be derecognized) when the asset no longer has an alternative use (i.e., when customization of the asset to the customer's specifications begins or the other criteria for revenue recognition over time are met). Once the criteria for recognition over time are met, control of the asset transfers to the customer as the asset is created.

[7] Quoted from paragraph 20 of TRG Agenda Paper 53.

8.5.2 Use of a Multiple Attribution Approach (as Compared With a Single Method for Measuring Progress)

As discussed in step 2 (see Chapter 5), an entity is required to identify all distinct goods or services in a contract with a customer, each of which represents a performance obligation. Certain promised goods or services in a contract may not be distinct but may be combined with other promised goods or services until they can be identified as a bundle of distinct goods or services, or as a series of goods or services. Step 5 requires an entity to record revenue as the performance obligation is satisfied at either a point in time or over time. For performance obligations meeting the requirements for revenue recognition over time, the entity must select a method for measuring progress toward satisfaction of the performance obligation.

Although the new revenue standard indicates that an entity should apply a single method to measure progress for each performance obligation satisfied over time, stakeholders have questioned whether an entity may apply more than one method to measure progress toward satisfaction of a performance obligation that contains multiple goods and services bundled and recognized over time. Examples of such circumstances include the following:

- A cloud computing company provides hosting services to its customers for specified periods that begin once certain up-front implementation activities are completed. The customer cannot access the services in the hosting arrangement until the implementation activities are complete (and no other vendor can perform the implementation). Therefore, the hosting services are combined with the up-front activities to be one performance obligation.
- A license is provided to a customer at contract inception. However, there is also a service associated with the license that is not considered to be distinct. Therefore, the service is combined with the license to be one performance obligation.
- A franchisor enters into a license agreement with a new franchisee for a specified number of years with a promise to also provide a fixed number of hours of consulting services in the first year of the agreement. The license is to be satisfied over time. Because both promises in the arrangement are highly interrelated, the license is combined with the consulting services into one performance obligation.

Stakeholders questioned whether it would be acceptable to apply two different methods for measuring progress even though the contract has only one performance obligation. This issue was addressed by the TRG.

TRG Update — Measuring Progress When Multiple Goods and Services Are in a Single Performance Obligation

In July 2015, the TRG discussed stakeholders' concerns that applying one measure of progress to all goods and services may be inconsistent with the new standard's principle regarding when to recognize revenue. Stakeholders also noted that (1) recognizing revenue in the same pattern for all goods and services may not accurately depict the economics of the transaction and (2) operational issues may arise when consideration for a performance obligation involving several goods or services contains multiple payment streams that vary among periods.

While there is diversity in practice under existing U.S. GAAP, the new revenue standard clearly indicates that "using multiple methods of measuring progress for the same performance obligation would not be appropriate."[8]

[8] Quoted from TRG Agenda Paper 41.

The TRG concluded that an entity should use a single measure of progress for each performance obligation identified in the contract.

TRG members observed that selecting a common measure of progress may be challenging when a single performance obligation contains more than one good or service or has multiple payment streams, and they emphasized that the selection is not a free choice. They also noted that while a common measure of progress that does not depict the economics of the contract may indicate that the arrangement contains more than one performance obligation, it is not determinative.

Q&A 8-9 Multiple Measures of Progress Toward Complete Satisfaction of a Performance Obligation

When a performance obligation is satisfied over time, an entity is required to identify an appropriate measure to depict progress toward complete satisfaction of its performance obligation (see ASC 606-10-25-31 through 25-37).

Question

When a single performance obligation satisfied over time consists of multiple promised goods or services, or both, can multiple measures of progress be used to depict an entity's progress toward complete satisfaction of that performance obligation?

Answer

No. ASC 606-10-25-32 states that an entity should apply a single measure of progress for each performance obligation. This applies even when that single performance obligation is made up of a number of goods or services.

Selecting a measure of progress may be challenging when a single performance obligation contains multiple goods or services or has multiple payment streams. Regardless of the number of goods, services, or payment streams in a performance obligation, an entity is required to identify a single measure of progress that appropriately depicts its progress toward complete satisfaction of the performance obligation.

When it proves difficult to identify a single measure of progress that accurately depicts an entity's progress toward complete satisfaction of a single performance obligation made up of a number of goods or services, the entity may need to reassess the performance obligations identified in the contract. A reexamination may suggest that the contract includes more performance obligations than were initially identified.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 8-10 Use of Different Methods of Measuring Performance to Date to Determine Whether a Performance Obligation Is Satisfied Over Time and to Measure Progress Toward Satisfaction of That Performance Obligation

ASC 606-10-25-27 states that performance obligations are satisfied 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 . . . .
>
> 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 . . . .

In some circumstances, an entity will need to identity a suitable method for measuring "performance completed to date" to determine whether the criterion in ASC 606-10-25-27(c) is met (see ASC 606-10-25-29 and ASC 606-10-55-11 for additional guidance). For example, an entity may measure performance completed to date for this purpose by considering costs incurred, in which case it would then need to consider whether, upon cancellation by the customer, it would receive compensation at least equal to the costs incurred plus a reasonable margin.

Once it has been determined that a performance obligation is satisfied over time, ASC 606-10-25-31 requires an entity to "recognize revenue over time by measuring the progress toward satisfaction of that performance obligation." ASC 606-10-25-33 through 25-35 and ASC 606-10-55-16 through 55-21 provide guidance on the methods that can be used to measure progress in this context.

Question

If an entity has used a particular method (e.g., a cost-based input method) to measure performance completed to date so that it can determine whether the conditions in ASC 606-10-25-27(c) are met, is the entity required to use that same method for measuring progress toward complete satisfaction of the performance obligation under ASC 606-10-25-31?

Answer

No. ASC 606 describes various methods for measuring progress, including input and output methods. For measuring both performance completed to date under ASC 606-10-25-27(c) and progress toward complete satisfaction of a performance obligation under ASC 606-10-25-31, the method selected should faithfully depict an entity's performance in transferring control of goods or services promised to a customer. However, there is no requirement for the same method to be used for both purposes.

But in determining an appropriate method for measuring progress under ASC 606-10-25-31, entities should be aware that ASC 606-10-25-32 requires them to apply the same method to all similar performance obligations in similar circumstances.

Example

Entity A enters into a contract with Customer B under which A will construct a large item of specialized equipment on its own premises and then deliver the equipment and transfer title to B after construction is completed. The specialized equipment is only suitable for this particular customer (i.e., it has no alternative use). In addition, the specialized equipment is subject to certain regulations that require third-party appraisals to be performed throughout the construction of the equipment. The objective of the appraisals is to assess the entity's construction progress and ensure that the equipment is built in accordance with published regulations. The results of the periodic appraisals are provided to the customer, and a final appraisal is performed shortly before the equipment is delivered to the customer.

Entity A concludes that it qualifies to recognize revenue over time under ASC 606-10-25-27(c) by using a cost-based input method because if the customer cancels the contract, the customer must reimburse the costs incurred by the entity to the date of cancellation and pay a 5 percent margin on those costs (which is considered to be a reasonable margin).

However, in measuring the progress toward satisfaction of similar performance obligations in other contracts, A uses an output method based on third-party appraisals completed to date. This method is determined to faithfully depict progress toward satisfaction of the performance obligation in the contract with B. Because ASC 606-10-25-32 requires an entity to apply the same method of measuring progress to similar performance obligations in similar circumstances, A uses this appraisal-based output method to measure the revenue to be recognized in each reporting period from its contract with B despite using a cost-based measure of progress to determine whether it met the criterion in ASC 610-10-25-27(c).

8.5.3 Application of the Method for Measuring Progress

ASC 606-10

25-34 When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

Under the control principle of the new revenue standard, it would not be appropriate for an entity to recognize revenue for any progress made or activities performed that do not transfer control to the customer. Rather, the entity should use judgment to determine which activities are included in the promised goods or services to the customer and select a method for measuring progress toward transferring the goods or services to the customer.

This concept is also aligned with principal-versus-agent considerations in that if the entity does not transfer control to the customer but coordinates the transfer directly to the customer from a third party (i.e., the entity does not control the good or service before it is transferred to the customer), it would be inappropriate to include the component part in the measure of progress, and revenue should therefore be adjusted accordingly. See Chapter 10 for further discussion of principal-versus-agent considerations.

8.5.4 Subsequent Measurement of an Entity's Measure of Progress

ASC 606-10

25-35 As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

It is highly likely that estimates related to an entity's level of progress will change as the entity fulfills its promise to the customer. As a result, such estimates of an entity's measure of progress should be updated on the basis of the most current information available to the entity. Consideration should be given to subsequent measurement to the extent that there are any changes in the outcome of the performance obligation. Such changes should be accounted for in a manner consistent with the guidance on accounting changes in ASC 250, which states that a "change in accounting estimate shall be accounted for in the period of change if the change affects that period only or in the period of change and future periods if the change affects both." Accordingly, a change in the entity's estimated measure of progress should be accounted for prospectively (i.e., prior periods are not restated). Because the change represents a change in accounting estimate rather than any change in the scope or price of the contract, the guidance in the new revenue standard on contract modifications (discussed in Chapter 9) would not apply. In addition, since this estimate is related to an entity's recognition of revenue rather than measurement of revenue, the guidance on accounting for changes in the estimate of variable consideration (discussed in Chapter 7) would not apply.

For example, assume that an entity enters into a contract to construct a building in exchange for a fixed price of $2 million. The entity concludes that it has a single performance obligation and that it meets one of the criteria for recognizing revenue over time. In addition, the entity concludes that an input method is the most appropriate method for measuring its progress toward complete satisfaction. Accordingly, the entity measures its progress on the basis of costs incurred to date as compared with total expected costs. At contract inception, the entity estimates that it will incur total costs of $900,000. After the entity incurs actual costs of $450,000, the entity's estimate of total costs changes from $900,000 to $800,000. This change represents a change in accounting estimate and should be accounted for as follows:

- *Amount of revenue recognized to date* — ($450,000 ÷ $900,000) × $2 million = $1 million.
- *Amount of revenue that should be recognized on the basis of the new estimate* — ($450,000 ÷ $800,000) × $2 million = $1.125 million.
- *Amount of revenue recognized upon change in estimate* — $1.125 million − $1 million = $125,000.

8.5.5 Reasonable Measure of Progress

ASC 606-10

Reasonable Measures of Progress

25-36 An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

ASC 606-10 (continued)

25-37 In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

As illustrated in Q&A 8-8 above, the new revenue standard requires an entity to select the method that most appropriately depicts its progress toward completion. However, in some circumstances, an entity may not be able to reasonably measure progress toward completion. This challenge is directly addressed in current U.S. GAAP (ASC 605-35, formerly SOP 81-1) and IFRSs (IAS 11). Under those standards, when an entity cannot accurately measure progress toward completion (typically at the beginning of a long-term contract), the entity is required to recognize revenue solely on the basis of the costs incurred (which results in zero margin being recognized) or, under U.S. GAAP, in accordance with the completed contract method.

During the development of the new revenue standard, feedback considered by the FASB and IASB suggested that recognizing revenue on this basis is a widely understood and reasonable practice. As a result, the boards carried forward this concept into the new revenue standard. Specifically, the boards concluded that if an entity cannot reasonably measure progress but still expects to recover the costs incurred to satisfy the performance obligation, the entity should recognize revenue for its progress in satisfying the performance obligation by recognizing revenue in the amount of the costs incurred. However, this would only be appropriate if the entity cannot reasonably measure its progress, or until the entity is able to reasonably measure progress. In addition, an entity may need to evaluate whether it is required to recognize losses in its financial statements before those losses are incurred. Refer to Chapter 12 for considerations related to onerous performance obligations and recognition of such losses.

Importantly, this evaluation is separate from estimating and constraining variable consideration. Therefore, in long-term contracts, there are typically at least two key estimates made at contract inception and reassessed during the contract: (1) the entity's current measure of progress and, separately, (2) the entity's current estimate of any variable consideration (see Chapter 6 for further discussion).

The Q&A below illustrates an example in which progress toward complete satisfaction of a performance obligation cannot be reasonably measured.

Q&A 8-11 Progress Toward Complete Satisfaction of a Performance Obligation Cannot Be Reasonably Measured — Example

A contractor enters into a building contract with fixed consideration of $1,000 (i.e., revenue is fixed). The contract is expected to take three years to complete and satisfies one of the criteria in ASC 606-10-25-27 for revenue to be recognized over time. At the end of year 1, management is unable to reasonably measure its progress toward complete satisfaction of the performance obligation (e.g., because it cannot reasonably measure total costs under the contract). Taking into account the progress to date and future expectations, management expects that total contract costs will not exceed total contract revenues. Costs of $100 have been incurred in year 1.

In this example, since the contractor is not able to reasonably measure the progress relative to the work performed to date but expects that costs are recoverable, only revenue of $100 should be recognized in year 1. Therefore, in year 1, revenue and costs of services of $100 are recognized, resulting in no profit margin.

When the FASB and IASB were developing the new revenue standard, they drew from legacy GAAP and measures of progress used in current practice. Both ASC 605-35 (formerly SOP 81-1) and IAS 11 include two categories of measures of progress, which the boards carried forward in the new revenue standard:

- Output measures.
- Input measures.

The sections below outline these separate measures of progress and provide examples of their use, including examples from the new revenue standard.

8.5.6 Output Methods

The new revenue standard outlines two types of methods for measuring progress: output methods and input methods. As stated in ASC 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." Examples of output methods include surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units delivered or produced. Value to the customer is an objective measure of the entity's performance.

ASC 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.

ASC 606-10

55-19 The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.

Paragraph BC164 of ASU 2014-09 states that the FASB and IASB "decided that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer." That is, the boards did not state that an output method is the preferred method but instead indicated that in most cases, an output method would be the most appropriate method that is consistent with recognizing revenue as value is transferred to the customer. Some stakeholders argue that an output method is generally the most appropriate method because the outputs used are directly observable and objectively determined. However, a drawback of using an output method is that there may not always be a directly observable output to reliably measure an entity's progress. As a result, the boards noted that there may be instances in which it would be appropriate for an entity to use an input method (i.e., if that method would be less costly and would provide a reasonable measure of progress).

In redeliberations of the new revenue standard, some stakeholders requested that the boards provide more guidance on when units-of-delivery or units-of-production methods would be appropriate. Although such methods appear to be output methods, they do not always provide the most appropriate depiction of the entity's performance. That is, these methods may disregard an entity's efforts that result in progress toward completion when performance is satisfied over time, which could be material to the contract or even the financial statements as a whole. In addition, units-of-production or units-of-delivery methods may not be appropriate in contracts that provide design and production services because the transfer of produced items may not correspond to the actual progress made on the entire contract.

Therefore, in the selection of an output method for measuring progress and the determination of whether a units-of-delivery or units-of-production method is appropriate, it is important for an entity to carefully consider (1) all of the facts and circumstances of the arrangement and (2) how value is transferred to the customer.

8.5.6.1 Practical Expedient for Measuring Progress

ASC 606-10

55-18 As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

The new revenue standard provides a practical expedient that can be applied to performance obligations that meet the criteria in ASC 606-10-25-27 to be satisfied over time. Most commonly referred to as the "invoice practical expedient," this option allows an entity to recognize revenue in the amount of consideration to which the entity has the right to invoice when the amount that the entity has the right to invoice corresponds directly to the value transferred to the customer. That is, the invoice practical expedient cannot be applied in all circumstances because the right to invoice a certain amount does not always correspond to the progress toward satisfying the performance obligation. Therefore, an entity should demonstrate its ability to apply the invoice practical expedient to performance obligations satisfied over time. Because the purpose of the invoice practical expedient is to faithfully depict an entity's measure of progress toward completion, the invoice practical expedient can only be applied to performance obligations satisfied over time (not at a point in time).

TRG Update — Using the Invoice Practical Expedient When the Unit Price or Rate Varies During the Contract Period

In applying the output method, an entity may use the invoice practical expedient, as discussed above. However, this option is available only if the invoice amount represents the "amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided)."[9]

Stakeholders have questioned whether the invoice practical expedient may be used for contracts in which the unit price or rate varies during the contract period. The TRG discussed this issue in July 2015.

TRG members agreed that an entity must use judgment and that conclusions are likely to vary depending on the facts and circumstances. They believed that the invoice practical expedient could be used for both a contract in which the unit price varies during the contract period and a contract in which the rate varies during the contract period because the contracts' respective price and rate changes might reflect the "value to the customer of each incremental good or service that the entity transfers to the customer."[10]

TRG members also discussed up-front and back-end fees, noting that while such fees do not preclude application of the invoice practical expedient, entities must use judgment in determining whether the value of the fee to the customer corresponds to the amount transferred to the customer.

The Q&As below illustrate the concepts discussed by the TRG related to the invoice practical expedient.

Q&A 8-12 Applying the Practical Expedient for Measuring Progress Toward Complete Satisfaction of a Performance Obligation to Contracts With Up-Front Consideration or Back-End Fees

The practical expedient in ASC 606-10-55-18 allows an entity to recognize revenue in the amount to which the entity has a right to invoice when that amount corresponds directly with the value to the customer of the entity's performance to date. For example, an entity may choose to use the practical expedient for a service contract in which the entity bills a fixed amount for each hour of service provided (see Example 42 (Contract A) in ASC 606-10-55-298 through 55-305).

Question

If a contract contains nonrefundable up-front consideration or back-end fees, does this in itself preclude an entity from applying the practical expedient in ASC 606-10-55-18?

[9] Quoted from ASC 606-10-55-18.
[10] Quoted from paragraph BC167 of ASU 2014-09.

Answer

No. An entity is not precluded from applying the practical expedient when a contract contains nonrefundable up-front consideration or back-end fees. However, the entity will need to use judgment in determining whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date.

When the entity makes this assessment, an analysis of the significance of the up-front or back-end fees relative to the other consideration in the arrangement is likely to be important.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 8-13 Applying the Practical Expedient for Measuring Progress Toward Complete Satisfaction of a Performance Obligation to Contracts With Rates That Vary Over the Contract Term

The practical expedient in ASC 606-10-55-18 allows an entity to recognize revenue in the amount to which the entity has a right to invoice when that amount corresponds directly with the value to the customer of the entity's performance to date. For example, an entity may choose to use the practical expedient for a service contract in which the entity bills a fixed amount for each hour of service provided (see Example 42 (Contract A) in ASC 606-10-55-298 through 55-305).

In some industries, the price charged to the customer for each unit transferred may vary over the contract term. For example, a contract to supply electricity for several years may specify different unit prices each year depending on the forward market price of electricity at contract inception.

Question

If a contract includes rates that vary over the contract term, does this in itself preclude an entity from applying the practical expedient in ASC 606-10-55-18?

Answer

No. An entity is not precluded from applying the practical expedient when the price per unit varies over the duration of the contract. However, the entity will need to use judgment in determining whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date.

In the example noted above, the contract to purchase electricity at prices that vary over the term of the contract depending on the forward market price of electricity at contract inception would qualify for the practical expedient because the rates per unit generally correlate to the value to the customer of the entity's provision of each unit of electricity.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

8.5.7 Input Methods

Input methods recognize revenue on the basis of an entity's efforts or inputs toward satisfying a performance obligation. Examples include resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used.

ASC 606-10

55-20 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.

8.5.7.1 Inefficiencies and Wasted Materials

ASC 606-10

55-21 A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).
b. [Omitted]

While an entity may conclude that an input method is the most appropriate method to measure progress of a contract (e.g., cost-to-cost method), there may be instances or anomalies in which costs incurred are attributable to inefficiencies or wasted materials and do not contribute to the satisfaction of the performance obligation. In these circumstances, an entity should exclude such factors that do not accurately depict the entity's progress toward satisfying the performance obligation.

In early drafts of the new revenue standard, the FASB and IASB proposed requiring an entity to exclude inefficiencies and wasted materials from any input measure (i.e., a cost-to-cost measure). However, many comment letter respondents explained that often there is an "expected" level of inefficiency or waste factored into a project from the outset and that separately, circumstances involving "unexpected" inefficiencies or waste may occur once a project has commenced. Those comment letter respondents requested further clarification from the boards regarding the amounts that should be excluded from any measure of progress. However, instead of providing additional detailed guidance on "expected" versus "unexpected" inefficiencies, the boards ultimately decided to emphasize the objective of measuring progress toward complete satisfaction of the performance obligation to depict an entity's performance in the contract. That is, when an input method is used, it should be adjusted if it is not truly depicting the measure of progress.

Q&A 8-14 Abnormal or Unexpected Wastage

In many construction and manufacturing contracts, some level of wastage is normal and unavoidable as part of the construction or manufacturing process. Expected levels of such wastage will be forecasted in an entity's budgets and estimates and included in contract costs. However, there may be circumstances in which an entity experiences significant unexpected levels of wasted materials, labor, or other resources.

Question

How should such abnormal wastage be accounted for?

Answer

ASC 606 contains specific guidance on accounting for costs to fulfill a contract. ASC 340-40-25-8(b) specifies that costs of wasted materials, labor, or other resources to fulfill a contract that are not reflected in the price of the contract should be recognized as expenses when incurred.

Abnormal waste costs do not represent additional progress toward satisfaction of an entity's performance obligation and, if revenue is being recognized over time, should be excluded from the measurement of such progress. If the entity is using costs incurred to date as an input method to measure progress toward complete satisfaction of its performance obligation, it should be careful to ensure that revenue attributed to work carried out is not increased to offset additional costs incurred when abnormal or excessive costs arise as a result of inefficiency or error. In particular, ASC 606-10-55-21(a) states that when using a cost-based input method, entities may be required to adjust the measure of progress when costs are incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract.

8.5.7.2 Uninstalled Materials

ASC 606-10

55-21 A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

a. [Omitted]

b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

   1. The good is not distinct.
   2. The customer is expected to obtain control of the good significantly before receiving services related to the good.
   3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
   4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

There may be instances in which an entity is acting as a principal and promises to deliver a good and a service that are not distinct from each other, but the good is transferred before the service is provided. For example, this could occur when a piece of equipment is transferred to the customer, but the entity has also promised to install the equipment or the piece of equipment is a component part of an overall highly customized project being provided to the customer. In these types of circumstances, a strict, literal interpretation of an input method to measure progress may not be appropriate, and the entity may need to carefully consider its actual progress toward completion. To assist in the interpretation of the new revenue standard's general guidance on input methods in these circumstances, the boards provided additional guidance (see ASC 606-10-55-21(b), reproduced above) and included an example illustrating the treatment of uninstalled materials (see Example 19, reproduced below).

Through both the additional guidance and the example, the boards clarified that the adjustment to the input method for uninstalled materials was to ensure that the input method is consistent with the objective of measuring progress toward complete satisfaction of a performance obligation.

In the scenario described above (delivery of equipment, including installation), if the entity delivers the equipment before it installs the equipment, it would be inappropriate to continue to recognize that equipment as inventory. Rather, the entity should recognize revenue for the entity's performance (i.e., for the delivery of the equipment) in accordance with the core principle of the standard. However, the boards acknowledged that an entity may have difficulty determining the amount of revenue to recognize for the delivery of the equipment when the delivery is not distinct from the installation. For example, if the entity were to use a cost-to-cost method to measure progress, resulting in recognition of a contract-wide profit margin for the delivery of the equipment, the entity's performance could consequently be overstated, resulting in an overstatement of revenue. Another option would be for the entity to estimate a profit margin (which differs from the contract-wide profit margin); however, this approach would be complex and could result in the recognition of too much revenue for the transfer of goods or services that are not distinct. Ultimately, the boards decided that in certain circumstances, an entity should only recognize revenue in the amount of the cost of those goods that have been transferred to the customer (and not include any amount of profit margins). This adjustment is necessary if delivery of the uninstalled good does not depict the entity's performance. This adjustment to the cost-to-cost measure of progress is most appropriate for scenarios in which the goods (e.g., the equipment) compose a large portion of the total cost of the contract, and it ensures that the input method meets the objective of measuring progress to depict the entity's performance.

In addition, the boards also clarified that if an entity selects an input method, (e.g., the cost-to-cost method), it would need to adjust the measure of progress if including some of the costs incurred would not truly depict entity's performance in the contract.

ASC 606-10

Example 19 — Uninstalled Materials

55-187 In November 20X2, an entity contracts with a customer to refurbish a 3-story building and install new elevators for total consideration of $5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are $4 million, including $1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs 606-10-55-36 through 55-40 because it obtains control of the elevators before they are transferred to the customer.

55-188 A summary of the transaction price and expected costs is as follows:

Transaction price	$	5,000,000
Expected costs:		
Elevators		1,500,000
Other costs		2,500,000
Total expected costs	$	4,000,000

55-189 The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation in accordance with paragraph 606-10-55-21. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators ($1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation ($4 million). The entity is not involved in designing or manufacturing the elevators.

55-190 The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph 606-10-55-21, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

55-191 As of December 31, 20X2, the entity observes that:

a. Other costs incurred (excluding elevators) are $500,000.
b. Performance is 20% complete (that is, $500,000 ÷ $2,500,000).

ASC 606-10 (continued)

55-192 Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	$ 2,200,000 [(a)]
Costs of goods sold	2,000,000 [(b)]
Profit	$ 200,000

(a) Revenue recognized is calculated as (20% × $3,500,000) + $1,500,000. ($3,500,000 is $5,000,000 transaction price – $1,500,000 costs of elevators.)

(b) Cost of goods sold is $500,000 of costs incurred + $1,500,000 costs of elevators.

Q&A 8-15 Illustration of an Input Method — Treatment of Prepaid Costs for Work to Be Performed in the Future

A contractor undertakes a three-year contract. At the end of year 1, management estimates that the total revenue on the contract will be $1,000 and that total costs will be $900, of which $300 has been incurred to date. Of the $300 incurred to date, $50 is related to materials purchased in year 1 that will be used in year 2. The materials purchased in advance are generic in nature and were not specifically produced for the contract. The contractor has determined that the contract is a single performance obligation that will be satisfied over time.

Question

Since the contractor is required to recognize revenue over time, how should the progress toward complete satisfaction of its performance obligation be calculated (assuming that the contractor calculates progress by using an input method based on the proportion of costs incurred to date compared to total anticipated contract costs)?

Answer

ASC 606-10-55-21 states that "an entity should exclude from an input method the effects of any inputs that . . . do not depict the entity's performance in transferring control of goods or services to the customer."

Materials purchased that have yet to be used do not form part of the costs that contribute to the transfer of control of goods or services to the customer. For example, if materials have been purchased that the contractor is merely holding at the job site, and these materials were not specifically produced or fabricated for any projects, transfer of control of such materials will generally not have passed to the customer.

Accordingly, in this example, an adjustment is required for the purchased materials not yet used because the materials are related to the work to be performed in the future, and control of the materials has not transferred to the customer, as illustrated below.

Cost incurred to date	$ 300
Less: materials purchased for later years	(50)
Costs incurred for work performed to date	$ 250
Total estimated costs	$ 900
Percentage completion at end of year 1	28%

Therefore, in year 1, contract revenue of $280 (28% of $1,000) and contract costs of $250 are recognized in profit or loss. Contract costs of $50 corresponding to the purchased materials not yet used are recognized as inventories. See also Section 8.5.3.

8.5.7.3 Incremental Costs to Obtain a Contract

When using an input method, an entity should exclude from its measure of progress costs incurred to obtain the contract with the customer because such costs do not depict an entity's performance under the contract. Chapter 12 discusses how to account for the incremental costs to obtain a contract with a customer.

Q&A 8-16 Excluding Costs of Obtaining a Contract From Measure of Progress

Question

When an entity uses an input method to measure progress, is it appropriate for the entity to include costs incurred to obtain a contract with a customer in the measurement of contract costs when measuring progress toward complete satisfaction of a performance obligation satisfied over time?

Answer

No. Under cost-based input methods, the costs of obtaining a contract should not be included in the measurement of progress to completion because they do not depict the transfer of control of goods or services to the customer. ASC 606-10-25-31 states that an entity's objective, when measuring progress, is to depict its performance in transferring control of goods or services promised to a customer. ASC 606-10-55-21 also specifies that inputs that do not depict such performance are excluded from the measurement of progress under an input method.

Costs of obtaining a contract are not a measure of fulfilling it and, accordingly, are excluded in the measurement of progress (both from the measure of progress to date and the estimate of total costs to satisfy the performance obligation) irrespective of whether they are recognized as an asset in accordance with ASC 340-40-25-1. Such assets are amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. Accordingly, rather than being used to determine the pattern of revenue recognition, capitalized costs of obtaining a contract are amortized in accordance with the expected pattern of transfer of goods or services.

8.5.8 Measuring Progress — Stand-Ready Obligations

As discussed in Section 5.4.2, step 2 of the revenue model (i.e., identify the performance obligations) addresses how to assess the nature of a stand-ready obligation on the basis of what, in fact, the entity is promising to deliver to the customer (i.e., a discrete set of performance obligations over a fixed period or a performance obligation that is unlimited over a fixed period). This concept is illustrated in Example 18 of ASC 606, which is reproduced below.

ASC 606-10

Example 18 — Measuring Progress When Making Goods or Services Available

55-184 An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay $100 per month.

55-185 The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a).

55-186 The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress toward complete satisfaction of the performance obligation over time is a time-based measure, and it recognizes revenue on a straight-line basis throughout the year at $100 per month.

Once an entity has assessed the nature of the obligation and determines that it would be appropriate to recognize revenue over time, it must determine an appropriate method to measure progress. The Q&A below expands on this concept and provides additional guidance on measuring progress toward complete satisfaction of a stand-ready performance obligation satisfied over time.

Q&A 8-17 Measuring Progress Toward Complete Satisfaction of a Stand-Ready Performance Obligation That Is Satisfied Over Time

ASC 606-10-25-18 lists types of promises in a contract that an entity should assess to determine whether they are distinct performance obligations. For example, ASC 606-10-25-18(e) describes a service of "standing ready" to provide goods or services ("stand-ready obligation"). The customer receives and consumes a benefit from a stand-ready obligation — namely, the assurance that a service or scarce resource (e.g., snow removal during the winter) is available to the customer when and if needed or called upon. See Q&A 5-9 for additional considerations related to whether a performance obligation is a stand-ready obligation or an obligation to deliver goods or services.

Sometimes, the nature of the entity's promise in a contract is to "stand ready" for a period rather than to provide the goods or services underlying the obligation (i.e., the discrete act of removing snow, as illustrated below). In the case of a stand-ready promise, the customer obtains (i.e., receives and consumes) a benefit from the assurance that a service or resource is available ("standing ready") when and if needed or desired. For a stand-ready obligation that is satisfied over time, an entity may measure progress toward complete satisfaction of the performance obligation by using one of various methods, including time-based, input, and output methods.

Question

How should an entity measure progress toward the complete satisfaction of a stand-ready obligation that is satisfied over time?

Answer

Although ASC 606-10-55-16 through 55-21 provide guidance on when an entity would use an output or input method, the guidance does not prescribe the use of either method. However, an entity does not have a "free choice" when selecting a measure of progress. While an entity may use either type of method, the actual method selected should be consistent with the clearly stated objective of depicting the entity's performance (i.e., the entity's satisfaction of its performance obligation in transferring control of goods or services to the customer).

Further, although ASC 606 does not permit an entity to default to a straight-line measure of progress on the basis of the passage of time (i.e., because a straight-line measure of progress may not faithfully depict the pattern of transfer), ASC 606 does not prohibit the use of a straight-line measure of progress, and such a time-based method may be reasonable in some cases depending on the facts and circumstances. An entity would need to use judgment to select an appropriate measure of progress on the basis of the arrangement's particular facts and circumstances.

Example 18 in ASC 606-10-55-184 through 55-186 illustrates a health club membership involving an entity's stand-ready obligation to provide a customer with one year of access to any of the entity's health clubs. In the example, the entity determines that the customer benefits from the stand-ready obligation evenly throughout the year.

Other examples of stand-ready obligations include the following:

- *Snow removal services* — An entity promises to remove snow on an "as needed" basis (i.e., a single amount is paid irrespective of the number of times the snow removal services are performed). In this type of arrangement, the entity does not know and most likely cannot reasonably estimate whether, how often, and how much it will snow. This suggests that the entity's promise is to stand ready to provide the snow-removal services on a when-and-if-needed basis. As a result, a time-based measure of progress may be appropriate. However, a pure straight-line recognition pattern over each month of an annual contract may not be reasonable if that would allow recognition of revenue during months (i.e., warmer months) when the entity either is not performing or is performing to a markedly reduced extent. For such a fixed-fee service contract, although the contract term is fixed (i.e., one year), the pattern of benefit of the services to the customer, as well as the entity's efforts to fulfill the contract, would most likely vary throughout the year because there would be less expectation of snowfall during the warmer months of the year.
- *Software upgrades* — An entity promises to make unspecified (i.e., when-and-if-available) software upgrades available to a customer. The nature of the entity's promise is fundamentally one of providing the customer with assurance that any upgrades or updates developed by the entity during the period will be made available because the entity stands ready to transfer updates or upgrades when and if they become available. The customer benefits from the guarantee evenly throughout the contract period because any updates or upgrades developed by the entity during the period will be made available. As a result, a time-based measure of progress over the period during which the customer has rights to any unspecified upgrades developed by the entity would generally be appropriate unless the entity's historical experience suggests that another method would more faithfully depict the pattern of transfer of the when-and-if-available upgrades to the customer.

The TRG discussed this issue in January 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 25. For additional information and Deloitte's summary, see Appendixes D and E.

Once an entity has determined the nature of the promise to the customer, the entity must determine how to appropriately recognize revenue. As discussed in Section 8.1.1, an entity must first go through steps 1 through 4 before applying step 5 to determine when to recognize revenue. Specifically, an entity must identify the nature of the promised goods and services and determine whether those goods and services are distinct (as described in Chapter 5) before determining the appropriate pattern of revenue recognition. As illustrated in the Q&A below, the pattern of revenue recognition may differ depending on the nature of the promised goods and services in the contract. Therefore, it is critical that an entity carefully assess the promised goods and services in the contract before jumping to revenue recognition in step 5. In some instances, an entity may be providing a service of standing ready to provide as many goods or services as needed by a customer when called upon. This promised service, as noted above, is commonly referred to as a "stand-ready obligation." However, in other instances, an entity may be available to provide goods or services when called upon by a customer, but the customer only has a right to a specified amount of goods or services. The examples in the Q&A below illustrate how an entity that is "standing ready" to provide goods or services when called upon would account for its performance obligation in both types of situations, whose respective patterns of revenue recognition differ from each other.

Q&A 8-18 Determining Whether a Contract Includes a Stand-Ready Obligation or an Obligation to Provide a Defined Amount of Goods or Services — Examples

Entity X enters into two different contracts, one with Customer A and the other with Customer B, to provide cloud computing capacity. Given the nature of X's business, very little incremental effort is required as X's customers use the cloud computing capacity.

Example 1

Contract With Customer A for Specified Quantity

Entity X enters into a three-year contract with A, under which A receives the right to a specified quantity of cloud computing capacity on an "as needed" basis. Unused capacity is forfeited at the end of the contract term. On the basis of historical usage, X does not expect A to use the cloud computing capacity evenly through the contract term but expects A to use all of the agreed capacity before the end of the contract.

As discussed in Q&A 5-11, for an entity to distinguish between a stand-ready obligation and an obligation to provide a defined amount of goods or services, it will often be helpful to focus on the extent to which the customer's use of a resource affects the remaining resources to which the customer is entitled.

In the circumstances described, the nature of X's promise is to provide a fixed capacity, and its performance under the contract is demonstrated by the actual discrete delivery of capacity. In contrast to the example in paragraph BC160 of ASU 2014-09 (see Q&A 5-11), when A uses cloud computing capacity, this *does* affect the amount of the remaining services to which it is entitled, indicating that X's promise is to deliver specified services rather than to stand ready.

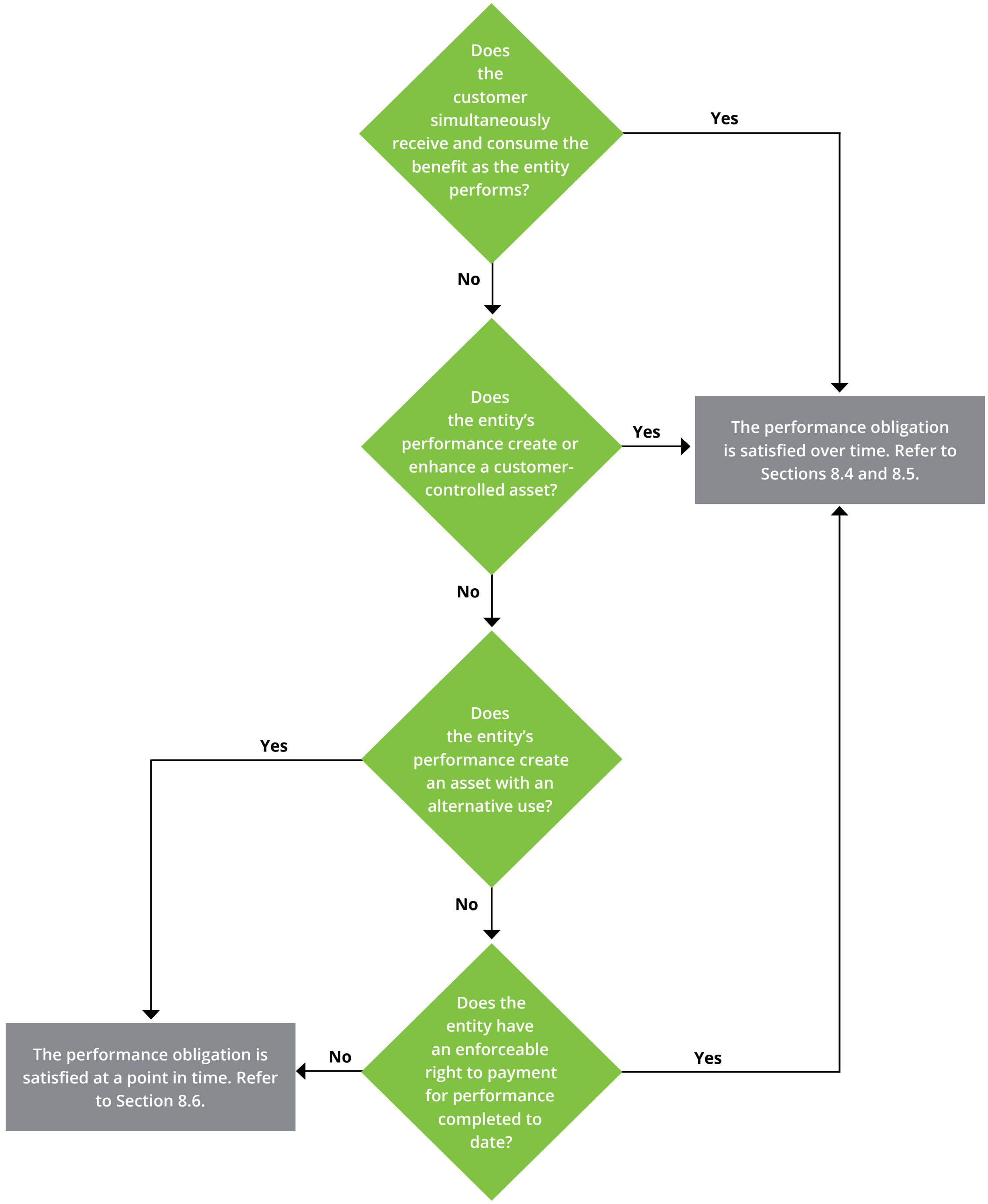
As a result, X should recognize revenue in a manner that is consistent with A's usage of the capacity during the reporting period (i.e., by applying a usage-based measure of progress). It would not be appropriate for X to recognize revenue by using a ratable or straight-line method.

Example 2

Contract With Customer B for Unlimited Quantity

In contrast to X's contract with A, X's contract with B is to provide unlimited cloud computing capacity as required over a three-year term. Because X has agreed to provide an unlimited quantity of cloud computing capacity, the nature of X's promise to B is to continuously stand ready to make unlimited cloud computing capacity available, and B's entitlement to future capacity is not affected by the extent to which B already used capacity. In such circumstances, straight-line revenue recognition might be an appropriate representation of X's transfer of control for this stand-ready obligation. However, X should consider information from similar contracts regarding historical patterns of performance in using judgment to select an appropriate measure of progress based on its service of making the cloud computing capacity available (which is not necessarily the same as when the customers use the capacity made available to them).

8.6 Revenue Recognized at a Point in Time



If a contract does not meet the criteria for recognition of revenue over time, revenue should be recognized at a point in time. That is, an entity must first evaluate the criteria in ASC 606-10-25-27 for recognizing revenue over time (see Section 8.4). Only after determining that none of the criteria in ASC 606-10-25-27 are met can the entity conclude that it is appropriate to recognize revenue at a point in time. Then, the entity must determine the specific point in time at which it is appropriate to recognize revenue for the contract (i.e., when control of the goods or services is transferred to the customer).

ASC 606-10

25-30 If a performance obligation is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset — If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefit from, the asset in exchange.
b. The customer has legal title to the asset — Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
c. The entity has transferred physical possession of the asset — The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.
d. The customer has the significant risks and rewards of ownership of the asset — The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
e. The customer has accepted the asset — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

Changing Lanes — Focus on Control

As discussed in Section 8.2, the shift from a risks-and-rewards model to a control-based model may result in revenue recognition patterns that differ from those previously recorded. When assessing the transfer of control, an entity should evaluate the point in time at which the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Specifically, this assessment should be performed from the customer's perspective (i.e., the entity should identify when the customer obtains control of the asset, not when the entity relinquishes control of the asset).

In initial proposals of the new revenue standard, the boards eliminated the concept of risks and rewards from the recognition of revenue. However, some respondents disagreed with excluding risks and rewards from the standard. Specifically, paragraph BC154 of ASU 2014-09 states, "Respondents observed that risks and rewards can be a helpful factor to consider when determining the transfer of control, as highlighted by the IASB in IFRS 10, *Consolidated Financial Statements*, and can often be a consequence of controlling an asset." Consequently, the boards decided to add risks and rewards as an indicator of control. Although risks and rewards may indicate that control has transferred, it is important to remember that this is only an indicator and that an entity should consider other factors when determining whether revenue should be recognized.

Paragraph BC155 of ASU 2014-09 states that the indicators in ASC 606-10-25-30 (reproduced above) "are not a list of conditions that must be met before an entity can conclude that control of a good or service has transferred to a customer. Instead, the indicators are a list of factors that are often present if a customer has control of an asset and that list is provided to assist entities in applying the principle of control."

The new revenue standard does not require any one specific indicator or all of the indicators listed above to be present for an entity to conclude that revenue should be recognized at a point in time. The Q&A below illustrates this concept and how an entity would reach the conclusion that revenue should be recognized at a point in time.

Q&A 8-19 Transfer of Control With Respect to Performance Obligations Satisfied at a Point in Time

ASC 606-10-25-23 states that "[a]n entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer." The transfer of the asset occurs "when (or as) the customer obtains control of that asset." ASC 606-10-25-25 defines control as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" or "the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

An entity should consider the indicators in ASC 606-10-25-30 when assessing the point at which control is transferred to the customer.

Question

Do all the indicators in ASC 606-10-25-30 need to be present for the transfer of control to have occurred with respect to performance obligations satisfied at a point in time?

Answer

No. The indicators in ASC 606-10-25-30 are not criteria that must be met before an entity can conclude that control of a good or service has been transferred to a customer. Rather, these indicators are factors that are often present if a customer has control of an asset and are provided to help entities apply the principle of control (see paragraph BC155 of ASU 2014-09). However, each indicator may not in isolation be sufficient to demonstrate the transfer of control (as noted in, for example, ASC 606-10-25-30(c) with respect to physical possession of an asset). An entity may therefore need to perform a careful analysis when one or more indicators are not present and the entity believes that control has been transferred.

The implementation guidance in ASC 606-10-55 includes additional guidance on assessing the transfer of control in certain contexts, such as repurchase agreements, consignment arrangements, bill-and-hold arrangements, customer acceptance, and trial-and-evaluation arrangements. When it is appropriate to do so, an entity should apply this guidance in addition to considering the indicators in ASC 606-10-25-30.

Typically, an entity would recognize revenue for the sale of goods at the point in time when control is transferred to the customer. As illustrated in Q&A 8-1, there are some instances in which it would be appropriate to recognize revenue for the transfer of goods over time; however, in instances in which the entity has concluded that point-in-time revenue recognition is appropriate, the timing of revenue may vary depending on the impact of governing laws. The Q&A below illustrates this concept.

Q&A 8-20 Transfer of Control of Goods to a Customer — Impact of Governing Laws

Under ASC 606, revenue is recognized when (or as) an entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

Question

If an entity sells the same item in a number of jurisdictions on exactly the same written contract terms, can the timing of revenue recognition differ between the jurisdictions?

Answer

Yes. It is not sufficient only to consider written contract terms in determining when control of an asset has been transferred to a customer. ASC 606 acknowledges that the timing of transfer of control can also be affected by governing laws.

- As indicated in ASC 606-10-25-29 and ASC 606-10-55-14, laws that apply to a contract may affect whether an entity has an enforceable right to payment for performance to date and, consequently, whether revenue should be recognized over time.
- In some jurisdictions, title does not legally transfer until the customer obtains physical possession of the goods.
- In some jurisdictions, property transactions (often residential property transactions) and distance sale transactions (such as sales via Internet, phone, mail order, or television) must include a period during which the customer has an absolute legal right to rescind the transaction (sometimes referred to as a "cooling off" period). For such transactions, it may be appropriate for entities to consider the guidance on whether a contract has been identified under ASC 606 and when customer acceptance occurs in determining the timing of revenue recognition.

8.6.1 Present Right to Payment for the Asset

ASC 606-10

25-30 [A]n entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset — If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
b. [Omitted]
c. [Omitted]
d. [Omitted]
e. [Omitted]

The first indicator that control has transferred for a performance obligation satisfied at a point in time is that the entity has a present right to payment for the asset (ASC 606-10-25-30(a)). If the customer is obligated to pay for the asset, this could be an indicator that control has transferred to the customer. As discussed above, this is only an indicator and is not a requirement for an entity to conclude that control has transferred to the customer and that the entity can recognize revenue.

8.6.2 Legal Title to the Asset

ASC 606-10

25-30 [A]n entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. [Omitted]
b. The customer has legal title to the asset — Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
c. [Omitted]
d. [Omitted]
e. [Omitted]

The second indicator that control has transferred for a performance obligation satisfied at a point in time is that the customer has legal title to the asset (ASC 606-10-25-30(b)). In a manner consistent with current U.S. GAAP, the transfer of control typically coincides with the transfer of legal title. As illustrated in Q&A 8-21 below, there may be limited instances in which the entity retains legal title to the asset but is not precluded from recognizing revenue. The Q&A illustrates an example in which it would be appropriate to recognize revenue at a point in time when the entity retains legal title to the asset.

Q&A 8-21 Retention of Title to Enforce Payment

As a matter of policy, a seller writes its sales contracts in such a way that legal title passes not upon delivery but rather when consideration for the goods is received. A transaction is entered into at an agreed, fixed price, and the related goods are delivered to a customer that is not a particular credit risk. At the point of delivery, the customer accepts and takes physical possession of the goods and incurs an obligation to pay for the goods. Assume that the criteria for recognizing revenue over time are not met.

Question

In these circumstances, is it appropriate for the seller to recognize revenue when the goods are delivered?

Answer

Yes. A core principle in ASC 606 is that revenue is recognized when (or as) an entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. As stated in ASC 606-10-25-25, control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset.

ASC 606-10-25-30 lists indicators for entities to consider when determining whether control has been transferred. The list is not intended to be exhaustive.

In the circumstances described, control of the goods has transferred from the seller to the customer even though title has not. Transfer of title may indicate that control of the asset has transferred to the customer, but it is not determinative. ASC 606-10-25-30(b) specifically states that "[i]f an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity [are protective rights and] would not preclude the customer from obtaining control of an asset." Consequently, as long as other indicators demonstrate that control of the asset has transferred to the customer, revenue should be recognized.

8.6.3 Transfer of Physical Possession of the Asset

ASC 606-10

25-30 [A]n entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. [Omitted]
b. [Omitted]
c. The entity has transferred physical possession of the asset — The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.
d. [Omitted]
e. [Omitted]

The third indicator that control has transferred for a performance obligation satisfied at a point in time is that the entity has transferred physical possession of the asset to the customer (ASC 606-10-25-30(c)). The customer's physical possession of the asset may indicate that the customer has obtained control of the asset. The standard, however, indicates that physical possession may not coincide with control of an asset. That is, in some arrangements (e.g., a contract with a repurchase agreement, or a consignment arrangement), the customer may have physical possession, but another aspect of the contract indicates that the entity still controls the asset. To the contrary, in a bill-and-hold arrangement, the entity may retain physical possession of the asset, but otherwise, the customer has obtained control. See Sections 8.6.6 and 8.6.7 below for further discussion of consignment arrangements and bill-and-hold arrangements, respectively.

8.6.4 Significant Risks and Rewards of Ownership

ASC 606-10

25-30 [A]n entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. [Omitted]
b. [Omitted]
c. [Omitted]
d. The customer has the significant risks and rewards of ownership of the asset — The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
e. [Omitted]

The fourth indicator that control has transferred for a performance obligation satisfied at a point in time is that the entity has transferred the significant risks and rewards of ownership to the customer (ASC 606-10-25-30(d)). While the new revenue standard shifts from a risks-and-rewards-based approach to a control-based approach, the boards intentionally included the "customer has the significant risks and rewards of ownership of the asset" as an indicator because it is still a helpful factor in the determination of whether control has transferred to the customer. In addition, it can often be a consequence of controlling the asset. This indicator was intended to provide additional guidance on determining whether control has transferred to the customer and does not change the principle of determining whether the goods or services have been transferred to the customer on the basis of control.

8.6.5 Customer Acceptance

ASC 606-10

25-30 [A]n entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. [Omitted]
b. [Omitted]
c. [Omitted]
d. [Omitted]
e. The customer has accepted the asset — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

The fifth and final indicator that control has transferred for a performance obligation satisfied at a point in time is that the customer has accepted the asset (ASC 606-10-25-30(e)).

ASC 606-10

55-85 In accordance with paragraph 606-10-25-30(e), a customer's acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity should consider such clauses when evaluating when a customer obtains control of a good or service.

55-86 If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognized before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.

55-87 However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because, in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

ASC 606-10 (continued)

55-88 If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

The significance of a customer acceptance clause in a contract can vary. For example, in some cases, a customer acceptance condition can be included as a substantive clause in a contract in which it is clear (perhaps even determinative) that without customer acceptance, control of the asset has not transferred to the customer. In other circumstances, a customer acceptance provision may not be explicit in the contract, or customer acceptance may be objectively determinable by the entity even before shipment to the customer. Therefore, it is important for the entity to consider the facts and circumstances of the arrangement as it considers the control indicators and, in particular, the guidance on evaluating customer acceptance in the overall assessment of transfer of control. Particularly in circumstances in which the entity cannot objectively conclude that the customer has accepted the asset, the entity may not be able to conclude that control has transferred to the customer.

8.6.6 Consignment Arrangements

Although physical possession is an indicator that control has transferred to the customer, ASC 606-10-25-30(c) cautions that there are some arrangements in which physical possession may not be indicative of control. One example is a consignment arrangement.

ASC 606-10

55-79 When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity should evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity should not recognize revenue upon delivery of a product to another party if the delivered product is held on consignment.

55-80 Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

a. The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.
b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).
c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

8.6.7 Bill-and-Hold Arrangements

Conversely to a customer in a consignment arrangement, a customer in a bill-and-hold arrangement may obtain control of the good before obtaining physical possession.

ASC 606-10

55-81 A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

ASC 606-10 (continued)

55-82 An entity should determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 606-10-25-30). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

55-83 In addition to applying the guidance in paragraph 606-10-25-30, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).
b. The product must be identified separately as belonging to the customer.
c. The product currently must be ready for physical transfer to the customer.
d. The entity cannot have the ability to use the product or to direct it to another customer.

55-84 If an entity recognizes revenue for the sale of a product on a bill-and-hold basis, the entity should consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 606-10-25-14 through 25-22 to which the entity should allocate a portion of the transaction price in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10

Example 63 — Bill-and-Hold Arrangement

55-409 An entity enters into a contract with a customer on January 1, 20X8, for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

55-410 Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On December 31, 20X9, the customer pays for the machine and spare parts but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts, and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse, and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years, and the entity does not have the ability to use the spare parts or direct them to another customer.

55-411 The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts, and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognized when (or as) control transfers to the customer.

55-412 Control of the machine transfers to the customer on December 31, 20X9, when the customer takes physical possession. The entity assesses the indicators in paragraph 606-10-25-30 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts, and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria in paragraph 606-10-55-83 are met, which is necessary for the entity to recognize revenue in a bill-and-hold arrangement. The entity recognizes revenue for the spare parts on December 31, 20X9, when control transfers to the customer.

55-413 The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity considers whether the payment terms include a significant financing component in accordance with paragraphs 606-10-32-15 through 32-20.

Driving Discussion — SAB Topic 13.A.3(a)

Historically, entities have looked to SEC guidance in SAB Topic 13.A.3(a) on when to recognize revenue for products sold in bill-and-hold arrangements.

Upon transition to ASC 606, the accounting for bill-and-hold arrangements may differ from the historical accounting under the guidance in SAB Topic 13. The interaction of this SAB topic with ASC 606 has not yet been determined. Refer to Chapter 19 for additional information about the SEC's activities related to the new revenue standard.

Q&A 8-22 Recognizing Revenue From the Sale of a Product in a Bill-and-Hold Arrangement

Company A manufactures its product only after receiving noncancelable purchase orders. At the end of the reporting period, customers from whom noncancelable purchase orders have been received may not yet be ready to take delivery of the product for various reasons (e.g., insufficient storage space, sufficient supply of the product in the customer's distribution channel, delays in the customer's production schedule). Accordingly, at a customer's request, A arranges to store the product either segregated in A's own warehouse or in a third-party warehouse. Company A retains legal title to the product, and payment by the customer depends on delivery to a customer-specified site.

Question

Can A recognize revenue from the sale of its product in a bill-and-hold arrangement?

Answer

ASC 606-10-55-83 provides that to recognize revenue from the sale of a product in a bill-and-hold arrangement, an entity must meet the requirements in ASC 606-10-25-30 related to the transfer of control in addition to the bill-and-hold criteria in ASC 606-10-55-83. Indicators of the transfer of control applicable to bill-and-hold arrangements include the following:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

In this case, the customer is not presently obligated to pay for the product, A retains legal title, and the customer does not have the significant risks and rewards of ownership. Therefore, the customer does not control the product, and revenue cannot be recognized.

8.6.8 Shipping Terms

For point-in-time revenue recognition, shipping terms may affect the point in time at which the entity recognizes revenue. Therefore, entities should carefully assess the indicators in ASC 606-10-25-30 to determine the point in time at which control transfers to the customer by considering the shipping terms in the contract. In addition to assessing step 5, entities should consider the guidance in step 2 of the new revenue standard on determining the nature of the promises (i.e., identifying performance obligations), as outlined in Chapter 5. Specifically, step 2 addresses (1) the determination of when shipping and handling is a performance obligation and (2) the FASB's related practical expedient.

The Q&As below illustrate how shipping terms may affect point-in-time revenue recognition.

Q&A 8-23 Impact of Specified Shipping Terms

Question

How do shipping terms affect the timing of revenue recognition?

Answer

Under ASC 606, revenue is recognized when (or as) an entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Therefore, in determining when to recognize revenue, an entity should evaluate when the customer obtains control of the asset by considering how the guidance in ASC 606 would be applied to the specific fact pattern.

If it is determined that revenue should be recognized at a point in time, an analysis of the shipping terms will form part of the assessment of when control passes. This is because shipping terms will typically specify when title passes and will also affect when the risks and rewards of ownership transfer to the customer; accordingly, they will be relevant in the assessment of two of the five indicators of transfer of control listed in ASC 606-10-25-30.

Q&A 8-24 Impact of Unspecified Shipping Terms

Question

When should revenue be recognized if the sales contract does not specify shipping terms?

Answer

Under ASC 606, revenue is recognized when (or as) an entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Therefore, in determining when to recognize revenue, an entity should evaluate when the customer obtains control of the asset by considering how the guidance in ASC 606 would be applied to the specific fact pattern.

If a written sales contract does not explicitly set out shipping terms, the following should be taken into account in the determination of when control of the goods has transferred to the customer:

- The standard shipping terms in the jurisdiction and in the industry.
- The legal environment of whichever jurisdiction governs the sale transaction.
- The entity's customary business practices, to the extent that they would be relevant to the contractual terms.

Q&A 8-25 Goods Shipped FOB Destination but Shipping Company Assumes Risk of Loss

Company A, which sells goods "free on board" (FOB) destination (i.e., title does not pass to the buyer until the goods reach the agreed destination), is responsible for any loss in transit. To protect itself from loss, A contracts with the shipping company for the shipping company to assume total risk of loss while the goods are in transit.

Question

Is it appropriate for A to recognize revenue when the goods are shipped?

Answer

No. Under ASC 606, A can only recognize revenue when it has satisfied its performance obligation by transferring control of the promised goods to the customer. As stated in ASC 606-10-25-25, control of an asset refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. ASC 606-10-25-30 states, in part:

> An entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:
>
> a. The entity has a present right to payment for the asset . . . .
>
> b. The customer has legal title to the asset . . . .
>
> c. The entity has transferred physical possession of the asset . . . .
>
> d. The customer has the significant risks and rewards of ownership of the asset . . . .
>
> e. The customer has accepted the asset.

Company A has not satisfied the performance obligation when the goods are shipped; the performance obligation is to provide the customer with the goods, whose title, risks and rewards of ownership, and physical possession will only be passed to the customer when the goods reach the agreed destination. Further, the fact that A has managed its risk while the goods are in transit by having a contract with the shipping company does not mean that it has transferred control of the goods to the customer at the time when the goods are shipped.

After performing the above analysis, A determines that control does not pass to the customer until the goods reach the agreed destination.

Generally, when goods are shipped with standard FOB destination shipping terms, control of the goods will be transferred to the customer when the goods arrive at the point of the agreed destination. However, entities should carefully consider both the terms of the contract and other relevant facts and circumstances to determine when control of the goods is transferred to the customer, especially when a contract contains other than standard shipping terms.

Q&A 8-26 "Synthetic FOB Destination" Shipping Terms

When goods are shipped FOB shipping point, title passes to the buyer when the goods are shipped, and the buyer is responsible for any loss in transit. On the other hand, when goods are shipped FOB destination, title does not pass to the buyer until delivery, and the seller is responsible for any loss in transit.

Certain companies that ship goods use FOB shipping point terms but have practices or arrangements with their customers that result in the seller's continuing to bear risk of loss or damage while the goods are in transit. If there is damage or loss, the seller is obligated to provide (or has a practice of providing) the buyer with replacement goods at no additional cost. The seller may insure this risk with a third party or "self-insure" the risk (however, the seller is not acting solely as the buyer's agent in arranging shipping and insurance in the arrangements). These types of shipping terms are commonly referred to as "synthetic FOB destination" shipping terms because the seller has retained the risk of loss or damage during transit so that **all** of the risks and rewards of ownership have not been substantively transferred to the buyer.

Question

How should a seller evaluate when control of goods is transferred to a customer under FOB shipping point terms if the company has a practice (or an arrangement with the customer) that results in the seller's continuing to bear the risk of loss or damage while the goods are in transit?

Answer

Under ASC 606, revenue is recognized when the seller "satisfies a performance obligation by transferring a promised good or service (that is, an asset)" to the buyer (customer); such a transfer occurs "when (or as) the customer obtains control of that asset." ASC 606-10-25-25 further explains the concept of "control" in the context of recognizing revenue. In evaluating these type of arrangements, a seller would first be required to determine whether control of a promised good is transferred over time (in accordance with specific criteria provided in ASC 606); if control is not transferred over time, the performance obligation would be deemed to be satisfied at a point in time. Under ASC 606-10-25-20, if control of the good (promised asset) is transferred at a point in time, the seller would consider indicators in determining the point at which the customer obtains control of the asset. Such indicators include, but are not limited to, the following:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

ASC 606 does not provide specific criteria that must be met but instead requires entities to consider each indicator (none of which are individually determinative) to determine when the buyer has obtained "control" of the asset. More specifically, paragraph BC155 of ASU 2014-09 states that "the indicators in paragraph 606-10-25-30 are **not a list of conditions that must be met** before an entity can conclude that control of a good or service has transferred to a customer. Instead, the indicators are a list of factors that are often present if a customer has control of an asset and that list is provided to assist entities in applying the principle of control in paragraph 606-10-25-23" (emphasis added).

When control of a good (that represents a separate performance obligation) is deemed to be transferred at a point in time, an entity would be required to use judgment in applying the guidance in ASC 606 and indicators to evaluate the impact of shipping terms and practices on the determination of when control of the good is transferred to the customer.

Under typical, unmodified FOB shipping point terms, the seller usually has a legal right to payment upon shipment of the goods; title and risk of loss of/damage to the shipped goods are transferred to the buyer, and the seller transfers physical possession of the shipped goods (assuming that the buyer, not the seller, has the ability to redirect or otherwise control the shipment through the shipping entity). Shipping terms generally do not affect a customer acceptance term, which the seller would have to evaluate separately to determine its impact on when control of a good is transferred to the buyer. However, if the seller can objectively determine that the shipped goods meet the agreed-upon specifications in the contract with the buyer, customer acceptance would be deemed a formality, as noted in ASC 606-10-55-86. Therefore, under typical unmodified FOB shipping point terms, the buyer would obtain control of the shipped goods, and revenue (subject to the other requirements of ASC 606) would be recognized upon shipment.

The typical FOB shipping point terms as described above may be modified such that a seller is either (1) obligated to the buyer to replace goods lost or damaged in transit (a legal obligation) or (2) not obligated but has a history of replacing any damaged or lost goods at no additional cost (a constructive obligation). Such an obligation is an indicator that the seller would need to consider in determining when the buyer has obtained control of the shipped goods. In these situations, the seller should evaluate whether the buyer has obtained the "significant" risks and rewards of ownership of the shipped goods even though the seller maintains the risk of loss of/damage to the goods during shipping. Such evaluation would include (1) a determination of how the obligation assumed by the seller affects the buyer's ability to sell, exchange, pledge, or otherwise use the asset (as noted in ASC 606-10-25-25) and (2) a consideration of the likelihood and potential materiality of lost or damaged goods during shipping. The determination of whether the significant risks and rewards have been transferred would constitute only one indicator (not in itself determinative) of whether the buyer has obtained control of the shipped goods and should be considered along with the other four indicators in ASC 606. Recognition of revenue upon shipment (subject to the other requirements of ASC 606) would be appropriate if the seller concludes that the buyer has obtained "control" of the goods upon shipment (on the basis of an overall evaluation of the indicators in ASC 606-10-25-30 and other guidance in ASC 606).

Thinking It Through — FOB Synthetic Destination

As discussed in Q&A 8-26 above, it is important to understand the shipping terms of an arrangement to determine when control of the good transfers to the customer. This is because the shipping terms often trigger some of the key control indicators (e.g., transfer of title and present right to payment). Therefore, a careful evaluation of shipping terms in a manner similar to their evaluation under current U.S. GAAP is critical to the assessment of transfer of control. Common shipping terms include FOB shipping point (title transfers to the customer at the entity's shipping dock) and FOB destination (title transfers to the customer at the customer's location).

Current practice, under a risks-and-rewards model, requires a careful evaluation of the entity's involvement during the period of shipment in FOB shipping point fact patterns. That is, when the entity replaces lost or damaged products during shipping even though the shipping terms are FOB shipping point, it is often inappropriate under current guidance to recognize revenue upon shipment because the risks and rewards of ownership did not pass to the customer at the shipping point. Such practice should be reevaluated under the new control-based model. While the fact that the customer has the significant risks and rewards of ownership is an indicator of control, that indicator may be overcome by the other indicators of control. As a result, it may be appropriate to recognize revenue upon shipment when the terms are FOB shipping point, even in instances in which the entity retains the risks associated with loss or damage of the products during shipment.

When FOB shipping point fact patterns are reassessed and control is determined to transfer upon shipment, the seller should consider whether the risk of loss or damage that it assumed during shipping gives rise to another performance obligation (a distinct service-type obligation) that needs to be accounted for separately in accordance with the new revenue standard. For example, such risk may represent another performance obligation if goods are frequently lost or damaged during shipping.

Further, entities should consider the practical expedient under U.S. GAAP (ASC 606-10-25-18B, added by ASU 2016-10) that allows entities the option to treat shipping and handling activities that occur after control of the good transfers to the customer as fulfillment activities. Entities that elect to use this practical expedient would not need to account for the shipping and handling as a separate performance obligation. Refer to Section 5.2.4.2 for additional information.

8.7 Repurchase Agreements

ASC 606-10

25-26 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs 606-10-55-66 through 55-78).

An entity that enters into a contract for the sale of an asset may also enter into an agreement to repurchase the asset. The repurchased asset may be the same asset originally sold, an asset that is substantially the same as the originally sold asset, or an asset of which the asset originally sold is a component. The repurchase agreement may be either a part of the original contract or a separate contract; however, the terms of the repurchase are agreed upon at inception of the initial contract. An arrangement in which the entity subsequently decides to repurchase the asset after transferring control would not constitute a repurchase agreement. Paragraph BC423 of ASU 2014-09 states that the

FASB and IASB decided that a subsequent agreement would not constitute a repurchase agreement because "the entity's subsequent decision to repurchase a good without reference to any pre-existing contractual right does not affect the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the good upon initial transfer."

The boards considered repurchase agreements in developing the guidance on control since repurchase agreements may affect whether the entity is able to conclude that control of the asset has transferred to the customer. The new revenue standard sets out three ways a repurchase agreement would typically occur (forward, call option, and put option). When the entity has an obligation or right to repurchase the asset (forward or call option), it is precluded from concluding that control has transferred to the customer given the nature of these options and should account for the contract as a lease or financing arrangement. When the arrangement includes a put option (an obligation for the entity to repurchase the asset at the customer's request), the entity will need to exercise more judgment to determine whether the customer has a significant economic incentive to exercise that right.

ASC 606-10

55-66 A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

55-67 Repurchase agreements generally come in three forms:

a. An entity's obligation to repurchase the asset (a forward)
b. An entity's right to repurchase the asset (a call option)
c. An entity's obligation to repurchase the asset at the customer's request (a put option).

8.7.1 Forward or Call Option

ASC 606-10

55-68 If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the contract as either of the following:

a. A lease in accordance with Topic 840 {Topic 842} on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale-leaseback {sale and leaseback} transaction. If the contract is part of a sale-leaseback {sale and leaseback} transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback {sale and leaseback} in accordance with Subtopic 840-40 {Subtopic 842-40}.
b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

ASC 606-10 (continued)

55-69 When comparing the repurchase price with the selling price, an entity should consider the time value of money.

55-70 If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer. The entity should recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).

55-71 If the option lapses unexercised, an entity should derecognize the liability and recognize revenue.

The following example in ASC 606 illustrates how a repurchase agreement that includes a call option would be accounted for as a financing arrangement:

ASC 606-10

Example 62 — Repurchase Agreements

55-401 An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

Case A — Call Option: Financing

55-402 The contract includes a call option that gives the entity the right to repurchase the asset for $1.1 million on or before December 31, 20X7.

55-403 Control of the asset does not transfer to the customer on January 1, 20X7, because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph 606-10-55-68(b), the entity accounts for the transaction as a financing arrangement because the exercise price is more than the original selling price. In accordance with paragraph 606-10-55-70, the entity does not derecognize the asset and instead recognizes the cash received as a financial liability. The entity also recognizes interest expense for the difference between the exercise price ($1.1 million) and the cash received ($1 million), which increases the liability.

55-404 On January 1, 20X7, the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.

Q&A 8-27 Accounting for Contracts With a Right to Recall a Product After Its “Sell-By” Date

Certain contracts, such as those between a perishable goods supplier (the “entity”) and its customer, include provisions permitting or obligating the entity to remove (and sometimes replace) out-of-date products (e.g., to ensure that the end consumers receive a certain level of product quality or freshness, or both). Under these circumstances, the entity does not have the unconditional right or obligation to repurchase the products at any time from the customer. Rather, the products must be past their “sell-by date” before the entity would repurchase the goods.

Question

Does a call option or forward that is dependent on the passing of an expiration date (such as the one discussed above) require a transaction to be accounted for as a lease or financing, in accordance with ASC 606-10-55-68, rather than as a sale?

Answer

No. In the type of scenario described above, it would be appropriate for the entity to account for such an arrangement in a manner similar to the accounting for a sale with a right of return (i.e., as variable consideration) rather than as a lease or a financing transaction.

In lease or financing arrangements, the customer does not have the ability to control the asset for the asset's economic life. This is because in these arrangements, the customer is constrained in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. For example, in a lease arrangement, the customer may not sell the asset even though it has physical possession of the asset. However, in the type of scenario described above, a customer is free to sell, consume, or otherwise direct the use of the product **unless** the product becomes out of date. That is, the entity's call option in such a scenario is a protective right to recall the goods upon their expiration, which does not prevent the customer from controlling the asset (i.e., selling it) before the asset's sell-by date.

8.7.2 Put Option

ASC 606-10

55-72 If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 840 {Topic 842} on leases unless the contract is part of a sale-leaseback {sale and leaseback} transaction. If the contract is part of a sale-leaseback {sale and leaseback} transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback {sale and leaseback} in accordance with Subtopic 840-40 {Subtopic 842-40}.

55-73 To determine whether a customer has a significant economic incentive to exercise its right, an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option.

55-74 If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

55-75 If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, should be accounted for as described in paragraph 606-10-55-70.

55-76 If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

55-77 When comparing the repurchase price with the selling price, an entity should consider the time value of money.

55-78 If the option lapses unexercised, an entity should derecognize the liability and recognize revenue.

The following example in ASC 606 illustrates how a repurchase agreement that includes a put option would be accounted for as a lease:

ASC 606-10

Example 62 — Repurchase Agreements

55-401 An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

[Case A omitted[11]]

Case B — Put Option: Lease

55-405 Instead of having a call option [as in Case A], the contract includes a put option that obliges the entity to repurchase the asset at the customer's request for $900,000 on or before December 31, 20X7. The market value is expected to be $750,000 on December 31, 20X7.

55-406 At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs 606-10-55-72 through 55-78). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

55-407 In accordance with paragraphs 606-10-55-72 through 55-73, the entity accounts for the transaction as a lease in accordance with Topic 840 {Topic 842} on leases.

Driving Discussion — Residual Value Guarantees

Throughout their discussions on repurchase agreements, the FASB and IASB also considered whether other arrangements should be accounted for as leases, such as those in which an entity provides its customer with a guaranteed amount to be paid on resale (i.e., a residual value guarantee). Respondents provided feedback indicating that such arrangements appeared to be economically similar to repurchase agreements and that accounting for such arrangements as leases would be consistent with current U.S. GAAP.

As noted in paragraph BC431 of ASU 2014-09, the boards made the following observation:

> [W]hile the cash flows [in repurchase agreements and residual value guarantees] may be similar, the customer's ability to control the asset in each case is different. If the customer has a put option that it has significant economic incentive to exercise, the customer is restricted in its ability to consume, modify, or sell the asset. However, when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset.

Accordingly, the boards decided that sales with a residual value guarantee should not be accounted for under the repurchase agreement implementation guidance in the new revenue standard. Rather, such arrangements should be accounted for in accordance with the general five-step model outlined in the standard.

[11] Case A of Example 62, on which Case B is based, is reproduced in Section 8.7.1 above.

8.7.3 Right of First Refusal in Connection With a Sale

Contracts may include terms that give the entity an option to repurchase the asset being sold to the buyer if the buyer subsequently plans to accept a bona fide offer from a third party to purchase the asset from the buyer. If the entity exercises its option, the repurchase transaction would be subject to terms and conditions that are similar to those in the bona fide offer the buyer received from the third party. Such terms are commonly referred to as a "right of first refusal."

Q&A 8-28 Evaluation of a Right of First Refusal in Connection With a Sale

When an entity sells an asset to a customer, the sales contract may include terms that give the seller an option to repurchase the asset being sold to the customer if the customer, at some point in the future, plans to accept a third party's bona fide offer to buy the asset. If the entity exercises its option, the repurchase transaction would be subject to terms and conditions that are similar to those in the bona fide offer that the customer received from the third party. In this situation, the entity's option to repurchase the asset is often referred to as a "right of first refusal."

ASC 606-10-55-68 states that "[if] an entity has an obligation or a right to repurchase the asset (a forward or call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset."

Question

Does a contract term that gives an entity a right of first refusal in the event that its customer receives a bona fide offer from a third party preclude the entity from recognizing a sale?

Answer

No. An entity's right of first refusal would not, on its own, prevent the customer from obtaining control of the asset (as defined in ASC 606-10-25-25).

A right of first refusal as described above allows the vendor to influence the determination of the party to whom the customer subsequently sells the asset but not whether, when, or for how much the subsequent sale is made. Consequently, the entity's right does not limit the customer's ability to direct the use of the asset or to obtain substantially all of the remaining benefits from the asset.

Example
Entity B enters into a contract to sell a building to Entity C. The contract's terms provide that if, after the sale, C receives a bona fide offer from an unaffiliated third party to purchase the building and C plans to accept the offer, B has the option to repurchase the building subject to terms and conditions that are similar to those contained in the offer C received from the third party. In the assessment of whether B has transferred control of the building to C, the right of first refusal, on its own, would not prevent C from obtaining control of the building.

8.8 Customers' Unexercised Rights — Breakage

ASC 606-10

55-46 In accordance with paragraph 606-10-45-2, upon receipt of a prepayment from a customer, an entity should recognize a contract liability in the amount of the prepayment for its performance obligation to transfer, or to stand ready to transfer, goods or services in the future. An entity should derecognize that contract liability (and recognize revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation.

55-47 A customer's nonrefundable prepayment to an entity gives the customer a right to receive a good or service in the future (and obliges the entity to stand ready to transfer a good or service). However, customers may not exercise all of their contractual rights. Those unexercised rights are often referred to as breakage.

55-48 If an entity expects to be entitled to a breakage amount in a contract liability, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine whether an entity expects to be entitled to a breakage amount, the entity should consider the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

55-49 An entity should recognize a liability (and not revenue) for any consideration received that is attributable to a customer's unexercised rights for which the entity is required to remit to another party, for example, a government entity in accordance with applicable unclaimed property laws.

Paragraph BC397 of ASU 2014-09 notes that the FASB and IASB decided to include in ASC 606-10-55-46 through 55-49 (paragraphs B44 through B47 of IFRS 15) specific implementation guidance on the accounting for breakage (i.e., "situations in which the customer does not exercise all of its contractual rights" to goods or services in the contract) in contracts for which there is only a single performance obligation. The boards note that in other arrangements (i.e., those with multiple performance obligations), breakage is generally addressed by the guidance on accounting for a material right (see Chapter 5) and the allocation guidance in step 4 (see Chapter 7 for further discussion). In light of this, the Q&As below take a deeper dive into the application of the new implementation guidance on breakage.

Q&A 8-29 Accounting for Sales of Gift Certificates That May Not Be Redeemed

Gift certificates sold by a retailer can be used by the holder to purchase goods up to the amount indicated on the gift certificate.

Question

When should the retailer recognize revenue arising from gift certificates?

Answer

Gift certificates typically represent a nonrefundable prepayment to an entity that gives the customer a right to receive goods or services in the future (and obliges the entity to stand ready to transfer the goods or services). Under ASC 606, revenue should be recognized when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer. In this case, the retailer satisfies its performance obligation when the customer redeems the gift certificate and the retailer supplies the associated goods or services to the customer. Accordingly, upon receipt of a prepayment from a customer, the retailer should recognize a contract liability for its performance obligation to transfer, or to stand ready to transfer, the goods or services in the future. The entity should derecognize that contract liability (and recognize revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation.

Customers may not exercise all of their contractual rights for various reasons. ASC 606 states that such unexercised rights are often referred to as breakage. Under ASC 606-10-55-46 through 55-49, breakage can be recognized in earnings before the vendor is legally released from its obligation in certain circumstances. For example:

- ASC 606-10-55-48 states, "If an entity **expects to be entitled** to a breakage amount in a contract liability, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer" (emphasis added). Under this approach, the estimated value of gift certificates that an entity expects will not be redeemed would be recognized as revenue proportionately as the remaining gift certificates are redeemed. For example, assume that a retailer issues $1,000 of gift certificates and, in accordance with ASC 606-10-32-11 through 32-13, expects that $200 of breakage will result on the basis of a portfolio assessment indicating that 20 percent of the value of all gift certificates sold will not be redeemed. Therefore, the proportion of the value of gift certificates not expected to be redeemed compared to the proportion expected to be redeemed is 20:80. Each time part of a gift certificate is redeemed, a breakage amount equal to 25 percent (20 ÷ 80) of the face value of the redeemed amount will be recognized as additional revenue (e.g., if a gift certificate for $40 is redeemed, the breakage amount released will be $10, such that the total revenue recognized is $50).

  Entities should not recognize breakage as revenue immediately upon the receipt of payment, even if there is historical evidence to suggest that for a certain percentage of transactions, performance will not be required. As noted in paragraph BC400 of ASU 2014-09, the FASB and IASB "rejected an approach that would have required an entity to recognize estimated breakage as revenue immediately on the receipt of prepayment from a customer. The Boards decided that because the entity has not performed under the contract, recognizing revenue would not have been a faithful depiction of the entity's performance and also could have understated its obligation to stand ready to provide future goods or services."

  To determine whether an entity expects to be entitled to a breakage amount, an entity should consider the requirements in ASC 606-10-32-11 through 32-13 on constraining estimates of variable consideration. The entity should use judgment and consider all facts and circumstances when applying this guidance.

- ASC 606-10-55-48 also states, "If an entity **does not expect to be entitled** to a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote" (emphasis added). For example, assume that a retailer issues $1,000 of gift certificates and applies the guidance in ASC 606-10-32-11 through 32-13 but concludes that it does not expect to be entitled to a breakage amount. Each time part of a gift certificate is redeemed, revenue will be recognized that is equal to the face value of the redeemed amount. Later, after $800 has been redeemed, the entity may determine that there is only a remote possibility that any of the outstanding gift certificate balances will in due course be redeemed. If so, the entity will release the remaining contract liability of $200 and recognize revenue of $200 at that time.

Q&A 8-30 Changes in Expectation of Breakage After Initial Allocation of Revenue

Entity A sells a product to Customer B and, as part of the same transaction, awards B a specific number of loyalty points that can be redeemed at a future date as and when the customer purchases additional products from A. The sale is made for cash consideration of $100, and no refund is available to the customer for unused loyalty points.

In accordance with ASC 606, A is required to allocate the revenue between the product sold and the loyalty points (material rights) that can be redeemed in the future. On the basis of a relative stand-alone selling price method (which would include expectations related to the level of loyalty points that will not be redeemed (i.e., "breakage")), A determines that the appropriate allocation is $80 to the product sold and $20 to the loyalty points.

Question

If, after the initial allocation of revenue, there is a change in estimate regarding the level of breakage, does this result in an amendment to the allocation of revenue between the product sold and the loyalty points?

Answer

No. Although the breakage guidance in ASC 606-10-55-48 specifically refers to the section on constraining estimates of variable consideration (the "constraint" in ASC 606-10-32-11 through 32-13), breakage is not a form of variable consideration because it does not affect the transaction price (in this example, A always remains entitled to the original cash consideration of $100).

In the absence of variable consideration, the requirement in ASC 606-10-32-14 to reassess the transaction price at the end of each reporting period does not apply. Therefore, a change in the estimate of breakage will not cause the original allocation of $80 to the product and $20 to the points to be amended.

The expected breakage could, however, affect the timing of recognition of revenue with respect to the $20 allocated to the loyalty points. This is because an entity that expects to be entitled to a breakage amount is required under ASC 606-10-55-48 to "recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer."

Similarly, if A sells gift cards on a stand-alone basis, the transaction price will be fixed at the amount paid by the customer irrespective of the expected breakage amount. Thus, the expected breakage affects only the timing of revenue recognition, not the total amount of revenue to be recognized, and therefore is not a form of variable consideration.

See Q&A 8-29 on accounting for sales of gift certificates that may not be redeemed.

Q&A 8-31 Recognition of Revenue Related to Options That Do Not Expire

In accordance with ASC 606-10-55-41 through 55-45, when an entity provides a customer with an option to acquire additional goods or services that results in a performance obligation because the option provides a material right to the customer, the entity should (1) allocate a portion of the transaction price to the material right and (2) recognize the related revenue either when the entity transfers control of the future goods or services or when the option expires.

Question

How should an entity recognize revenue related to a customer's option to acquire additional goods that is a material right to the customer but does not expire?

Answer

The answer will depend on whether the material right is (1) included in a portfolio of similar rights provided by the entity or (2) accounted for as an individual right. If the material right is included in a portfolio of similar rights, revenue related to expected unexercised options should be recognized in proportion to the pattern of rights exercised by the customers in the portfolio. If the customer option is an individual right, the entity would recognize revenue attributed to the material right when the likelihood that the customer will exercise the option is remote.

The guidance on options requires an entity to estimate the stand-alone selling price of the option at contract inception by considering the likelihood that the option will be exercised. An entity should also consider the guidance in ASC 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether it expects to be entitled to revenue related to unexercised options.

An entity would estimate the amount of revenue related to options that the entity expects the customer will not exercise by applying the guidance on unexercised rights in ASC 606-10-55-46 through 55-49. If there are any changes in the likelihood of exercising the option, the entity should recognize such changes as it measures progress toward satisfaction of the performance obligation. Accordingly, the entity should recognize revenue as follows:

- Recognize revenue for the portion of the transaction price allocated to the option when the option is exercised.
- If the option has not been exercised, recognize revenue either (1) in proportion to the pattern of rights exercised by customers (for material rights included in a portfolio of similar rights) or (2) at the point in time when the entity determines that the likelihood that the customer will exercise the option becomes remote (when accounting for a single material right).

Example 52 in the new revenue standard (ASC 606-10-55-353 through 55-356) demonstrates the allocation and recognition of changes in the expected redemption of loyalty program points (i.e., options). See Section 5.6.2.1 for further discussion.

Example 1

Loyalty Points

An entity has a loyalty rewards program that offers customers 1 loyalty point per dollar spent; points awarded to the customers do not expire. The redemption rate is 10 points for $1 off future purchases of the entity's products.

During a reporting period, customers purchase products for $100,000 (which reflects the stand-alone selling price of the products) and earn 100,000 points that are redeemable for future purchases. The entity expects 95,000 points to be redeemed.

The entity estimates the stand-alone selling price to be $0.095 per point (totaling $9,500) on the basis of the likelihood of redemption in accordance with ASC 606-10-55-44. The points provide a material right to the customers that they would not receive without entering into a contract. Therefore, the entity concludes that the promise to provide points to the customers is a performance obligation.

The entity therefore allocates, at contract inception, the transaction price of $100,000 as follows:

> *Products* — $100,000 × ($100,000 stand-alone selling price ÷ $109,500) = $91,324.
>
> *Loyalty points* — $100,000 × ($9,500 stand-alone selling price ÷ $109,500) = $8,676.

After one year, 20,000 points have been redeemed, and the entity continues to expect a total of 95,000 points to be redeemed. Therefore, the entity recognizes $1,827 in revenue for the 20,000 points redeemed ((20,000 points redeemed ÷ 95,000 total points expected to be redeemed) × $8,676). The entity also recognizes a contract liability of $6,849 ($8,676 − $1,827) for the unredeemed points at the end of year 1.

After two years, only 50,000 points in total have been redeemed. The entity then reassesses the total number of points that it expects the customers to redeem. Its new expectation is that 70,000 (i.e., no longer 95,000) points will be redeemed. Therefore, the entity recognizes $4,370 in revenue in year 2. To calculate this amount, the entity determines what portion of the $8,676 is to be recognized in year 2, adjusting the total expected points to be redeemed from 95,000 to 70,000:

> $4,370 = [(50,000 total points redeemed ÷ 70,000 total points expected to be redeemed) × $8,676] – $1,827 recognized in year 1.

The contract liability balance is $2,479 ($6,849 − $4,370).

After three years, 55,000 points in total have been redeemed, and the entity concludes that the likelihood that the customers will redeem the remaining 15,000 points is remote. Therefore, the entity recognizes revenue for the 5,000 points redeemed and the 15,000 points that are not expected to be redeemed. The total revenue recognized would be the remaining contract liability that was not yet recognized as revenue at the end of year 2 ($2,479).

Example 2

Single Customer Option

An entity enters into a contract with a customer for the sale of Product A for $100. As part of the negotiated transaction, the customer also receives a coupon for 50 percent off the sale of Product B; the coupon does not expire. Similar coupons have not been offered to other customers.

The stand-alone selling price of Product B is $60. The entity estimates a 70 percent likelihood that the customer will redeem the coupon. On the basis of the likelihood of redemption, the stand-alone selling price of the coupon is concluded to be $21 ($60 sales price of Product B × 50% discount × 70% likelihood of redemption) in accordance with ASC 606-10-55-44.

Example 2 (continued)

The entity concludes that the option to purchase Product B at a discount of 50 percent provides the customer with a material right. Therefore, the entity concludes that (1) this option is a performance obligation and (2) a portion of the transaction price for Product A should be allocated to this option.

The entity therefore allocates, at contract inception, the $100 transaction price as follows:

- *Product A* — $100 × ($100 stand-alone selling price ÷ $121) = $83.
- *Product B* — $100 × ($21 stand-alone selling price ÷ $121) = $17.

The option is not exercised during the first four years after its issuance. As a result, the entity determines that no revenue should be recognized during this period by applying the guidance in ASC 606-10-55-48, which allows revenue to be recognized "in proportion to the pattern of rights exercised by the customer." At the end of year 4, the entity determines that the likelihood that the customer will redeem the coupon has become remote and therefore recognizes the $17 in accordance with ASC 606-10-55-48.

8.9 Other Considerations in Step 5

8.9.1 Transfer of Control in Licensing Arrangements

The FASB and IASB acknowledged that because of the intangible nature of licenses, license arrangements create unique challenges in the application of the revenue framework. For that reason, the boards provided within their implementation guidance some additional guidance on assessing license arrangements.

The application of the control-based model in the delivery of licenses requires a comprehensive understanding of the entity's arrangement with a customer and an understanding of the type of intellectual property (IP) that is subject to the license agreement. A contract that includes a right to use software can be viewed as a contract for a good or a service. For example, software that relies on an entity's IP and is delivered only through a hosting arrangement (i.e., the customer cannot take possession of the software) is a service, whereas a software arrangement that is provided through an access code or key is more like the transfer of a good. In light of these unique characteristics, the boards established the additional implementation guidance to assist in the assessment of how and when the entity transfers control of its IP through a license to the customer since that control is transferred over time in some cases and at a point in time in other cases.

In determining whether the transfer of a license occurs over time or at a point in time, an entity should consider the indicators of the transfer of control to determine the point in time at which a license is transferred to the customer. ASC 606-10-55-58C states that revenue from a license of IP cannot be recognized before both of the following:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.

b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

Section 11.5.3 further explores transfer of control related to licensing arrangements.

8.9.2 Partially Satisfied Performance Obligations Before the Identification of a Contract

Entities sometimes begin activities on a specific anticipated contract with their customer before (1) the parties have agreed to all of the contract terms or (2) the contract meets the criteria in step 1 (see Chapter 4) of the new revenue standard. The FASB and IASB staffs refer to the date on which the contract meets the step 1 criteria as the “contract establishment date” (CED) and refer to activities performed before the CED as “pre-CED activities.”

TRG Update — Pre-CED Activities

The FASB and IASB staffs noted that stakeholders have identified two issues with respect to pre-CED activities:

- How to recognize revenue from pre-CED activities.
- How to account for certain fulfillment costs incurred before the CED.

The TRG discussed these issues in March 2015.

TRG members generally agreed with the staffs’ conclusion that once the criteria in step 1 have been met, entities should recognize revenue for pre-CED activities on a cumulative catch-up basis (i.e., record revenue as of the CED for all satisfied or partially satisfied performance obligations) rather than prospectively because cumulative catch-up is more consistent with the new revenue standard’s core principle.

The Q&A below demonstrates the application of the TRG’s general agreement.

Q&A 8-32 Partial Satisfaction of a Performance Obligation Before Identification of the Contract — Revenue Recognition

Sometimes, pre-CED activities result in the transfer of a good or service to the customer on the date the contract meets the criteria in ASC 606-10-25-1 (e.g., when the customer takes control of the partially completed asset) such that a performance obligation meeting the criteria in ASC 606-10-25-27 for recognition of revenue over time is partially satisfied.

The TRG discussed this issue in March 2015; a summary of the TRG’s discussion is available in TRG Agenda Paper 34. For additional information and Deloitte’s summary, see Appendixes D and E.

Question 1

In such circumstances, should revenue be recognized on the date the contract meets the criteria in ASC 606-10-25-1?

Answer

Yes. On that date, the entity should recognize revenue on a cumulative catch-up basis that reflects the entity’s progress toward complete satisfaction of the performance obligation.

In calculating the required cumulative catch-up adjustment, the entity should consider the requirements in ASC 606-10-25-23 through 25-37 with respect to determining when a performance obligation is satisfied to determine the goods or services that the customer controls on the date the criteria in ASC 606-10-25-1 are met.

Question 2

How should an entity account for fulfilment-type costs incurred in the period before identification of the contract?

Answer

It depends. If other Codification topics are applicable to those costs, the entity should apply the guidance in those other Codification topics. If it is determined that other Codification topics are not applicable, an entity should capitalize such costs as costs to fulfill an anticipated contract, subject to the criteria in ASC 340-40-25-5. On the date the criteria in ASC 606-10-25-1 are met, such costs would immediately be expensed if they are related to progress made to date or to services already transferred to the customer.

Costs that do not satisfy the criteria in other Codification topics or in ASC 340-40-25-5 for recognition as an asset (e.g., general and administrative costs that are not explicitly chargeable to the customer under the contract) should be expensed as incurred in accordance with ASC 340-40-25-8.

Example 1

In this example, assume that the criteria for recognizing revenue over time are met. In practice, whether those criteria are met will depend on a careful evaluation of the facts and circumstances.

An entity is constructing a piece of specialized equipment to an individual customer's specifications. Because of a delay in obtaining the customer's approval for the contract, the entity commences work on constructing the equipment before the contract is signed. Consequently, the costs that meet the criteria in ASC 340-40-25-5 that the entity incurs in performing this work are initially capitalized. Subsequently, the contract is approved, and the terms of the contract are such that the criteria for recognition of revenue over time are met. On the date the contract is signed and the criteria in ASC 606-10-25-1 are met, a cumulative catch-up of revenue (and expensing of capitalized costs), reflecting progress made to date, should be recognized for the partially constructed equipment.

Example 2

In this example, assume that the criteria for recognizing revenue over time are met. In practice, whether those criteria are met will depend on a careful evaluation of the facts and circumstances.

An entity is constructing an apartment block, in a foreign jurisdiction, consisting of 10 apartments. In the period before commencing construction, the entity has signed contracts (meeting the criteria in ASC 606-10-25-1) with customers for six of the apartments in the apartment block but not for the remaining four. The entity uses standard contract terms for each apartment, such that the entity (1) is contractually restricted from readily directing the apartment for another use during its construction and (2) has an enforceable right to payment for performance completed to date.

For the six apartments for which contracts have been signed with customers, the construction of each apartment represents the transfer of a performance obligation over time because the criteria in ASC 606-10-25-27(c) are met. Accordingly, revenue is recognized as those six apartments are constructed, reflecting progress made to date, and the costs incurred in relation to those six apartments are expensed to the extent that they are related to progress made to date.

For the four apartments for which contracts have not yet been signed with customers, costs that meet the criteria in ASC 340-40-25-5 are initially capitalized. Subsequently, on the date a contract is signed with a customer for one of those four apartments and the criteria in ASC 606-10-25-1 are met, a cumulative catch-up of revenue (and expensing of related capitalized costs) should be recognized for that apartment.

There may be instances in which an entity has transferred goods or services to the customer but has not met the requirements of step 1 in ASC 606-10-25-1 (i.e., one of the five required criteria is not met). For example, the entity may not have met the criterion stating that "[i]t is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer." In these instances, the entity must evaluate whether it is able to record a receivable to reflect its right to payment for performance completed before meeting the step 1 criteria.

ASC 606-10-45-4 states that a "receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. . . . An entity shall account for a receivable in accordance with [ASC] 310." Refer to Chapter 4 (step 1) for considerations related to how an entity should account for a receivable before the contract existence criteria are met.

Driving Discussion — Trial Periods

In a manner consistent with the discussion in Section 4.2.4 on free trial periods, entities may need to consider the effect of trial periods on contracts with customers. An entity must evaluate whether a contract exists during a trial period and, if so, the appropriate timing of revenue recognition during the trial period. Factors to consider include whether the trial period is risk-free, whether the customer has an obligation to make further purchases beyond the trial period, and whether the goods or services transferred during the trial period are, in fact, performance obligations. This determination may require an entity to use judgment on the basis of the specific facts and circumstances of the arrangement.

Two types of trial periods that an entity may participate in to solicit customers are (1) "risk-free" trials (i.e., the customer is not committed to a contract until after some of the goods or services are delivered) and (2) the delivery of "free" goods or services upon execution of a contract (i.e., a contract under the new revenue standard exists when the free goods or services are delivered). As noted above, it is essential to evaluate whether a contract with a customer exists under the new revenue standard to determine whether the goods or services provided during the trial period are performance obligations to which revenue should be allocated and recognized when control transfers. In addition, consideration should be given to whether the entity's performance obligation to transfer the goods or services during the trial period is satisfied at a point in time or over time (i.e., partly during the trial period and partly during the contractual period). Such factors are likely to affect the determination of whether and, if so, when revenue is recognized for the goods or services provided during the trial period.

8.9.3 Up-Front Fees

Arrangements may include up-front fees (e.g., activation fees or nonrefundable deposits) before any goods or services are transferred to the customer. Entities must determine whether any goods or services are transferred in exchange for the up-front fee, or whether the transfer of goods or services has not yet commenced.

When up-front fees are included in an arrangement, an entity must first identify the performance obligations (see Section 5.7 for additional discussion about determining the nature of a promise and identifying performance obligations). To the extent that a separate performance obligation is not identified, any up-front payment becomes a portion of the overall transaction price (see Chapter 6 for further discussion about determining the transaction price).

The Q&As below illustrate how an entity should evaluate and record up-front fees.

Q&A 8-33 Recognition of Up-Front Fees Received Upon Entering Into a Contract

Question

When an entity enters into a contract with a customer, it sometimes receives some or all of the consideration up front, before transferring the promised goods or services to the customer (i.e., before satisfying the performance obligation). In such a circumstance, can the up-front fee be recognized as revenue immediately when it is received, irrespective of when the performance obligation is satisfied?

Answer

No. Under ASC 606, the timing of recognition of revenue is not based on cash receipt or payment schedules. Instead, an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring control of a promised good or service to a customer.

When consideration is received by an entity before the related performance obligation is satisfied, the advance payment should not be recognized as revenue until that obligation is satisfied. Instead, the entity should recognize the consideration received as a contract liability (i.e., deferred revenue) in its statement of financial position.

This treatment is required even if the consideration received up front is nonrefundable since the goods or services may not have been transferred to the customer. Specifically, ASC 606-10-55-51 states, in part:

> In many cases, even though a nonrefundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer . . . . Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognized as revenue when those future goods or services are provided.

Further, ASC 606-10-55-53 states, in part:

> An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in [ASC] 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with [ASC] 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer.

Q&A 8-34 Up-Front Fees Received Upon Entering Into a Contract — Club Membership Fees

An entity operates a fitness club. The key terms of its contractual arrangements with customers are as follows:

- Customers have to pay an initiation fee of $100 upon entering into the contract.
- Each contract has a term of one year. During the contractual period, customers are required to pay a monthly fee of $100 (irrespective of their usage of the club during that month).
- The initiation fee is not refundable, even if the customer never uses the club during the one-year contract period.

Question

Should the entity recognize the initiation fee as revenue upon receipt, on the basis that it is nonrefundable?

Answer

No. Under ASC 606, an entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer.

In this example, customers pay the initiation fee and monthly fees to use the facilities provided by the fitness club. The performance obligation is therefore to provide fitness club facilities for customers' use. Hence, the initiation fee is just part of the consideration paid by customers to use the facilities in the future. No performance obligation has been satisfied upon payment of that fee and therefore revenue should not be recognized immediately in profit or loss when that consideration is received.

Instead, the initiation fee should be recognized as a liability. Such consideration would be included in the transaction price and recognized as revenue when (or as) the associated performance obligations are satisfied, which may include the identification of a material right.

8.9.4 Sales Commissions

An entity may earn revenue in the form of a sales commission; the treatment of sales commissions (i.e., the timing of recognizing the revenue related to the sales commission) may vary depending on the terms of the arrangement. In some cases in which an entity acts as an agent, it is providing a service over time; however, in other instances, an agent only provides its service at a point in time (typically, upon the completion of the transaction by the ultimate customer). See Chapter 10 for further discussion of principal-versus-agent considerations.

The Q&A below discusses whether revenue related to commissions earned by a sales agent should be recognized at a point in time or over time.

Q&A 8-35 Timing of Recognition of Revenue Related to Commissions Earned by a Sales Agent

Question

When a sales agent earns a fee in the form of a commission, should revenue be recognized at a point in time or over time?

Answer

The timing of recognition for such commission revenue depends on the nature of the agreement between the sales agent and its customer (the principal). Revenue will be recognized at a point in time unless the criteria in ASC 606-10-25-27 are met. Accordingly, it is appropriate to focus on ASC 606-10-25-27(a) and ASC 606-10-25-27(c):

- Does the principal simultaneously receive and consume the benefits provided by the sales agent's performance as the sales agent performs?
- Does the sales agent have an enforceable right to payment for performance completed to date?

In accordance with ASC 606-10-55-6, when the first of these criteria is assessed, it will be appropriate to consider whether another entity would need to substantially reperform the work that the sales agent has completed to date if that other entity were to fulfill the remaining performance obligation to the principal.

Often, the only promise that a sales agent makes to the principal is to arrange a sale, and the sales agent is only paid commission if it achieves a sale. In these circumstances, the criterion in 606-10-25-27(a) will typically not be met. Further, if another entity were to take over from the sales agent, typically that other entity would need to substantially reperform the work that the sales agent has completed to date. Thus, the conditions for recognizing revenue over time are not met, and a "good or service" is not considered to be transferred until a sale is made. In these instances, revenue should not be recognized until the sale is completed. The agent may perform activities before a sale, but these activities are often performed on the agent's own behalf to fulfill the promise made to the customer, which is to complete the sale. Although there may be some limited benefit to the customer as a result of the sales agent's presale activities, that benefit is significantly limited unless a sale transaction is ultimately completed.

This conclusion is consistent with Example 45 of the new revenue standard (ASC 606-10-55-317 through 319), which concludes that "[w]hen the entity satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), the entity recognizes revenue in the amount of the commission to which it is entitled." The use of the word "when" suggests that this is at a point in time, whereas the use of the word "as" would have implied that the entity is delivering, and the customer is receiving, a good or service over time.

In some instances, a sales agent may receive nonrefundable consideration at the outset of an arrangement, which may indicate that the customer is receiving a benefit from the activities performed before the sale. That is, the agent in these circumstances may be delivering an additional service during the contractual period (e.g., a listing service). However, the mere existence of such an up-front payment does not in itself indicate that a good or service has been transferred before the ultimate sale. In all cases, careful consideration of the contractual arrangement is required, and revenue should be recognized over time only if the contract meets one of the criteria in ASC 606-10-25-27.

Example 1

Revenue Recognized Upon Completion of the Sale

A sales agent enters into an arrangement with a seller in which it promises to arrange for buyers to purchase the seller's products. The agent performs various tasks to locate a buyer, including listing the products on its Web site. Once a buyer is located, the agent facilitates the purchase of the product on its Web site. The agent receives a commission equal to 10 percent of the sales price of the product when a sale is completed. The seller also pays the agent a small up-front fee to help cover costs incurred by the agent before the sale. The up-front fee is nonrefundable (i.e., the sales agent retains the fee even if the product is not sold). The up-front fee is expected to represent approximately 5 percent of the contract consideration received by the agent, and the commission represents the remaining 95 percent.

In this example, the promise to the customer is to arrange for the sale; therefore, the performance obligation is satisfied at the time of the sale. The agent should recognize the up-front fee and commission at the point in time when the sale is completed. The listing service in this example is an activity that the agent performs to satisfy its promise (i.e., to achieve the sale), but it does not transfer a good or service to the customer.

Example 2

Revenue Recognized Over Time

A sales agent enters into an arrangement with a seller in which it promises to list the seller's products on its Web site for a specified period in a manner similar to that of an online classified ad. If a buyer decides to purchase the seller's product, the buyer separately contacts the seller to complete the transaction. The agent receives a fee from the seller for the listing service. This fee is nonrefundable even if the product is not sold. If the product is sold, the agent also receives a commission equal to 1 percent of the sales price of the product. The listing fee is expected to represent approximately 80 percent of the contract consideration received by the agent, and the commission represents the remaining 20 percent.

In this example, the promise to the customer is the listing service. This performance obligation is satisfied over time as the customer receives the benefit of the listing (the customer simultaneously receives and consumes the benefit). Therefore, the agent should recognize the contract consideration over the listing period. The significant up-front payment is one indicator that the promise to the customer in this example is the listing service (as opposed to a promise to arrange for a sale, as in Example 1 above). The commission represents variable consideration that the agent should estimate and include in the transaction price, subject to the constraint.

Example 3

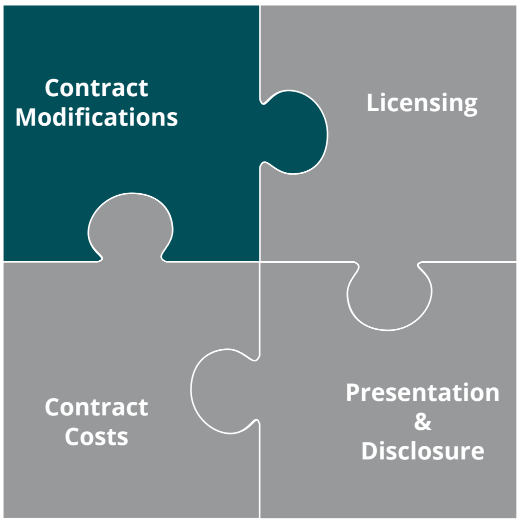
Two Separate Performance Obligations

A sales agent enters into an arrangement with a seller in which it promises to arrange for buyers to purchase the seller's products. The products are listed on the agent's Web site, and potential buyers are able to search for and view the products. In addition, the agent agrees to advertise the product on its Web site for a fixed price per day based on the length or content of the advertisement (e.g., number of words, pictures). The seller also purchases optional "upgrade" features for an additional fee, such as premium placement of the advertisement. The seller determines the number of days to run the advertisement and the content of the advertisement. The fees for the advertisement are nonrefundable even if the product is not sold. Once a buyer is located, the agent facilitates the purchase of the product on its Web site. The agent receives a commission equal to 5 percent of the sales price of the product when a sale is completed. The nonrefundable fee for the advertisement is expected to represent approximately 50 percent of the contract consideration received by the agent, and the commission represents the remaining 50 percent.

In this example, there are two distinct promises to the customer: the advertisement and the promise to arrange for the sale. The promises are distinct because the purchase of the advertisement is optional and the seller could sell its product on the Web site without the advertisement. The agent also sells advertisements separately to other customers. The advertising service is satisfied over time because the customer simultaneously receives and consumes the benefit over the period the advertisement is run. The promise to arrange for the sale is satisfied at the time of sale. The agent should estimate the total consideration, including the variable consideration (subject to the constraint) and allocate the consideration to the two performance obligations on the basis of stand-alone selling prices.

If the promises were not considered distinct, the combined performance obligation may be satisfied over time (for the same reasons the advertising service is satisfied over time when it is distinct). The agent would determine the estimated transaction price, including variable consideration (subject to the constraint), and recognize revenue by using an appropriate measure of progress.

Chapter 9 — Contract Modifications



9.1 Defining a Contract Modification

ASC 606-10

25-10 A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply the guidance in this Topic to the existing contract until the contract modification is approved.

25-11 A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

Contract modifications can frequently happen in the normal course of business. Any time an entity and its customer agree to change what the entity promises to deliver or the amount of consideration the customer will pay, there is a contract modification. Therefore, the first step in the identification of a contract modification is to assess whether, for a contract accounted for under ASC 606, there has been a change in the contract's scope or price, or both. The second step is to determine whether the parties to the contract have agreed upon the change. As defined above, contract modifications must be agreed to by both parties (written, orally, or through customary business practices). That is, both parties must agree to change the enforceable rights and obligations of the contract.

However, the requirement that a contract modification must be agreed to by both parties does not mean that the parties must be in full agreement on all details. For example, there can be situations in which both parties agree to modify a contract but there is discrepancy about the amount of consideration to be paid. Instead of determining whether all of the terms of a contract modification have been agreed to, an entity should assess whether it has the right to be compensated for satisfying the modified contract. Making this determination will require judgment. Further, a modification can be accounted for as either a separate contract or a combined contract, as discussed below.

Under current U.S. GAAP, guidance on contract modifications is limited to industry-specific guidance, such as guidance on certain modifications to construction- and production-type contracts within the scope of ASC 605-35 (formerly SOP 81-1). Further, various terms are used under current guidance to describe different types of changes to contracts. Examples of those terms include, but are not limited to, "claim," "change order," and "variation," as defined in the following table:

Term	Definition in ASC 605-35	Definition in IAS 11
Claim	"Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs."	"A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work."
Change order (U.S. GAAP) or variation (IFRSs)	"Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. They may be initiated by either the contractor or the customer, and they include changes in specifications or design, method or manner of performance, facilities, equipment, materials, sites, and period for completion of the work. Many change orders are unpriced; that is, the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. For some change orders, both scope and price may be unapproved or in dispute."	"A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract."

The purpose of the contract modification guidance in the new revenue standard is to create a single framework for accounting for modifications that will enable entities to account for them consistently across all industries. Therefore, claims, change orders, variations, or other terms that refer to a change in a contract should be evaluated in accordance with the new revenue standard's contract modification guidance.

Changing Lanes — Impact of the New Revenue Standard's Contract Modification Guidance

The new revenue standard provides a general framework for contract modifications that may differ from the framework previously applied by an entity. The goal of the new revenue standard's contract modification guidance, as stated in paragraph BC76 of ASU 2014-09, is to provide a general framework that can be used across industries to reflect entities' rights and obligations in modified contracts. For the FASB and IASB to create a framework that could be applied across multiple industries, it was necessary for the boards to define what should be considered a contract modification and determine the appropriate framework for accounting for contract modifications. As a result, an entity's accounting for contract modifications may or may not change under the new revenue standard depending on its former accounting policy.

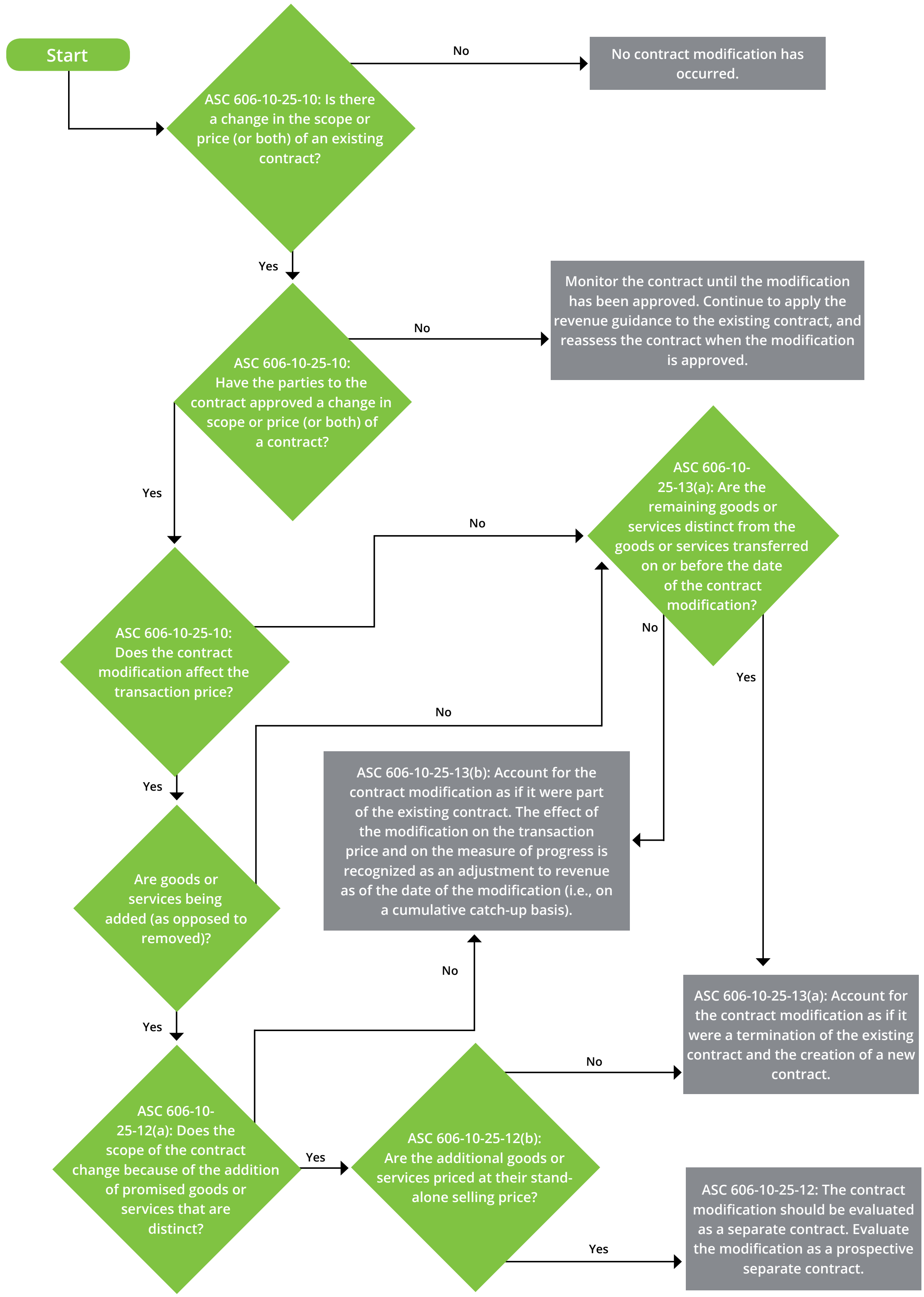
See also the guidance on addressing modifications during transition in Chapter 15.

9.2 Types of Contract Modifications

A contract modification can occur as a result of an approved change to a contract's scope or price (or both) that is communicated in writing, orally, or in accordance with an entity's customary business practice. If a change in a contract qualifies as a contract modification under ASC 606-10-25-10 and 25-11, the entity must assess the goods and services and their selling price. Depending on whether those goods and services are distinct or sold at the stand-alone selling price, a modification can be accounted for as:

- A separate contract (see ASC 606-10-25-12).
- One of the following (if the modification is **not** accounted for as a separate contract):
  - A termination of the old contract and the creation of a new contract (see ASC 606-10-25-13(a)).
  - A cumulative catch-up adjustment to the original contract (see ASC 606-10-25-13(b)).
  - A combination of the items described in ASC 606-10-25-13(a) and 25-13(b), in a way that faithfully reflects the economics of the transaction (see ASC 606-10-25-13(c)).

The following flowchart explains the decisions needed to (1) identify modifications made to a contract and (2) determine how an entity should account for each type of contract modification:


Start
ASC 606-10-25-10: Is there a change in the scope or price (or both) of an existing contract?
No
No contract modification has occurred.
Yes
ASC 606-10-25-10: Have the parties to the contract approved a change in scope or price (or both) of a contract?
No
Monitor the contract until the modification has been approved. Continue to apply the revenue guidance to the existing contract, and reassess the contract when the modification is approved.
Yes
ASC 606-10-25-10: Does the contract modification affect the transaction price?
No
ASC 606-10-25-13(a): Are the remaining goods or services distinct from the goods or services transferred on or before the date of the contract modification?
No
Yes
Yes
Are goods or services being added (as opposed to removed)?
No
ASC 606-10-25-13(b): Account for the contract modification as if it were part of the existing contract. The effect of the modification on the transaction price and on the measure of progress is recognized as an adjustment to revenue as of the date of the modification (i.e., on a cumulative catch-up basis).
Yes
ASC 606-10-25-12(a): Does the scope of the contract change because of the addition of promised goods or services that are distinct?
No
Yes
ASC 606-10-25-12(b): Are the additional goods or services priced at their stand-alone selling price?
No
ASC 606-10-25-13(a): Account for the contract modification as if it were a termination of the existing contract and the creation of a new contract.
Yes
ASC 606-10-25-12: The contract modification should be evaluated as a separate contract. Evaluate the modification as a prospective separate contract.

9.2.1 Contract Modification Accounted for as a Separate Contract

With the overall goal of accurately representing the economics of the transaction in mind, the FASB and IASB decided that there is no economic difference between (1) the modification of an existing contract with a customer to include additional distinct goods or services at their representative stand-alone selling price and (2) a completely new contract entered into by the two parties. Therefore, a contract modification should be accounted for as a separate contract only if there are additional *distinct* goods or services promised to a customer as a result of the modification. However, for the contract modification to be accounted for as a separate contract, those goods or services must be in exchange for consideration that represents the stand-alone selling price of the additional distinct promised goods or services.

When considering whether the price charged to the customer represents the stand-alone selling price of additional distinct promised goods or services, entities are allowed to adjust the stand-alone selling price to reflect a discount for costs they do not incur because they have modified a contract with an existing customer. For example, the renewal price that an entity charges a customer is sometimes lower than the initial price because the entity recognizes that the expenses associated with obtaining a new customer can be excluded from the renewal price to provide a discount to the existing customer. This lower renewal price may be the stand-alone selling price of additional distinct goods or services provided in the renewed contract.

ASC 606-10

25-12 An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).

b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

Thinking It Through — Determining How to Account for a Modification

If a modification is accounted for as a separate contract in accordance with ASC 606-10-25-12, the original contract is treated as unmodified for the purposes of ASC 606. However, if a contract modification does not qualify for the accounting under ASC 606-10-25-12, determining how to account for the modification can be more challenging.

For example, assume that Company X has entered into a contract to provide a customer with 100 units of Product A over 10 years. Five years into the term of the original contract, the contract is modified by agreement of the parties to provide the customer with an additional 25 units of Product B at Product B's stand-alone selling price. In addition, both products are capable of being distinct and are distinct within the context of the contract. Therefore, on the basis of these two factors, the modification would be treated as a separate contract.

In contrast, assume that X agrees to provide the customer with 25 more units of Product A instead of Product B. The additional units are the same as the previous Product A provided to the customer. Company X would have to determine as of the date of the modification whether it is selling the additional units of Product A at their stand-alone selling price at the time of the modification. As previously mentioned, five years have passed between the original contract and the modification. Assuming that the price of Product A has increased over this time, X has to determine the stand-alone selling price of the additional goods to be delivered to determine how to account for the modification. Specifically, if the additional goods are being sold at their then-current stand-alone selling price, the modification would represent a separate contract; but if the additional goods are not being sold at their then-current stand-alone selling price, the modification would be accounted for as a termination of the existing contract and the creation of a new contract.

ASC 606-10

Example 5 — Modification of a Contract for Goods

55-111 An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case A — Additional Products for a Price That Reflects the Standalone Selling Price

55-112 When the contract is modified, the price of the contract modification for the additional 30 products is an additional $2,850 or $95 per product. The pricing for the additional products reflects the standalone selling price of the products at the time of the contract modification, and the additional products are distinct (in accordance with paragraph 606-10-25-19) from the original products.

55-113 In accordance with paragraph 606-10-25-12, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognizes revenue of $100 per product for the 120 products in the original contract and $95 per product for the 30 products in the new contract.

9.2.2 Contract Modification Not Accounted for as a Separate Contract

ASC 606-10

25-13 If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
   1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and
   2. The consideration promised as part of the contract modification.

b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).

c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

A contract modification that does not meet the requirements outlined in Section 9.2.1 above is not accounted for as a separate contract. Therefore, an entity would have to determine how to account for a blended contract that now includes one or both of the following:

- An original agreement plus or minus some other goods or services.
- A change in the amount of consideration due under the modified arrangement.

The determination of which model to use depends on whether the remaining goods or services (the originally promised items and the newly promised items) are *distinct* from the goods and services already provided under the contract.

If the remaining goods or services are distinct from those already provided under the original arrangement, the entity would in effect establish a "new" contract that includes only those remaining goods and services. In this situation, the entity would allocate to the remaining performance obligations in the contract (1) consideration from the original contract that has not yet been recognized as revenue and (2) any additional consideration from the modification.

In contrast, if the contract modification results in remaining goods and services that are not distinct, the entity should account for the modification as though the additional goods and services were an addition to an incomplete performance obligation. This may be the case in a situation involving a construction-type contract to build a single complex when the original contract includes certain specifications and, as the construction progresses, the parties modify the terms to change certain requested features of the complex. In this instance, a measure of progress would typically be used to recognize revenue. For example, suppose that just before the modification, the entity's performance was 30 percent complete.

After the modification, the entity may determine that its performance is only 25 percent complete (or 35 percent complete). As a result, an updated revenue figure is calculated on the basis of the revised percentage, and the entity would record a cumulative catch-up adjustment.

The FASB and IASB recognized that there may be contracts in which some performance obligations include remaining goods or services that are distinct from those already provided under the original arrangement, while other performance obligations include remaining goods and services that are not (i.e., a change in scope of a partially satisfied performance obligation). In those circumstances, the boards decided that it may be appropriate, as described in ASC 606-10-25-13(c), to apply each of the models to parts of a contract. An entity would do so by accounting for the performance obligations that are not yet fully satisfied (i.e., including those that are partially satisfied). No change would be made to revenue recognized for fully satisfied performance obligations.

Thinking It Through — Repetitive Versus Accumulating Performance Obligations

Contract modifications will have different accounting implications for different types of performance obligations (i.e., repetitive or accumulating). An example of a repetitive performance obligation would be one in which an entity delivers relatively the same good or service to a customer numerous times over an agreed-upon period. An example of an accumulating performance obligation would be one in which an entity performs many procedures over time to produce the final good or service to be provided to a customer.

The examples below illustrate how an entity would account for a modification with repetitive or accumulating performance obligations that meet the requirements of ASC 606-25-13(a) or (b).

Example 9-1

Company A has a contract with Customer B to provide 10 widgets at $10 per widget. The $10 represents the stand-alone selling price of the widget. Customer B pays A the full consideration amount of $100 up front. These widgets will be delivered to B over five years. Assume that the contract does not have a significant financing component.

After three years, 5 widgets have been delivered to B (and revenue of $50 has been recognized), but B decides that it wants an additional 15 widgets (a total of 25 widgets). Company A agrees to sell the additional 15 widgets to B for $4 per widget. This price does not represent the stand-alone selling price of the widgets, and it is adjusted by more than the normal expenses that A would incur to obtain a new customer.

If each of the widgets in the original contract were determined to be distinct (see Chapter 5 for further analysis), A would apply the guidance in ASC 606-10-25-13(a) to this fact pattern because the remaining widgets are also distinct goods but are not sold at their stand-alone selling price. Therefore, A would reallocate the remaining consideration of both the original contract ($50) and the modification ($60) to the remaining performance obligations. In this example, A would allocate $110 across the remaining 20 widgets. As each widget is delivered, $5.50 would be recognized as revenue for A.

Example 9-2

Assume that the original contract in Example 9-1 above was determined to contain a single performance obligation that included an extensive and highly customized integration service that in effect reworked each widget as additional widgets were developed. Therefore, Company A identified a single performance obligation to deliver to Customer B a complete solution (that includes the original 10 widgets). Also assume that (1) revenue in the fact pattern is being recognized over time in accordance with ASC 606-10-25-27 and (2) as of the date of modification, but before the contract is actually modified, B has concluded that the contract is 40 percent complete. Company A has determined that the additional 15 widgets are not distinct from the original 10 widgets and that together, both sets of widgets still form a comprehensive solution (a single project) that is being delivered to the customer.

Under these new facts, A would combine the goods and services from the original contract and the modification to the contract. No allocation is necessary since there is only a single performance obligation. However, A would need to determine the extent to which it has completed its modified performance obligation.

Assume that A determines that the modified performance obligation is now 20 percent complete. Further assume that before the modification, A recorded $40 of revenue ($100 × 40%). Upon modification, A would record an entry in the amount of −$8 ($160 × 20%, or $32, less $40) to catch up on previously recognized revenue to represent A's performance to date on the basis of the modified contract terms. Subsequently, A would recognize the remaining $128 ($160 − $32) as it completely satisfies the remaining performance obligation.

The following table lays out the facts of Examples 9-1 and 9-2 side by side for comparison:

	Fact Pattern 1	**Fact Pattern 2**
Contract length	1/1/2015 through 12/31/2020	1/1/2015 through 12/31/2020
Obligation	Deliver 10 widgets	Integrate 10 widgets
Consideration	$10 per widget	$100 for integration
Modification date	1/1/2018	1/1/2018
Performance completed to date	5 widgets delivered	40% integrated
Total remaining consideration	$50	$60
Additional goods and services	Deliver 15 additional widgets	Integrate 15 additional widgets
Price for additional goods and services	$4 per widget	$4 per widget
Total additional consideration	$60	$60
Are the additional goods and services both capable of being distinct and distinct in the context of the contract?	Yes	No
Additional goods and services at stand-alone selling price?	No	No
Applicable modification guidance	ASC 606-10-25-13(a)	ASC 606-10-25-13(b)
Cumulative catch-up?	No	Yes
Cumulative catch-up amount	N/A	($100 + $60) × 20% = $32 $100 × 40% = $40 Cumulative catch-up = –$8
Consideration to recognize prospectively	(5 × $10) + (15 × $4) = $110 10 – 5 + 15 = 20 Revenue per widget = $5.50	$128 recognized as remaining performance obligation is satisfied

TRG Update — Contract Asset Treatment in Contract Modifications

Unlike current U.S. GAAP, under which there is limited guidance on accounting for modifications of revenue contracts, the new revenue standard provides an overall framework for modification accounting. For example, under the new standard, when a contract modification meets the conditions in ASC 606-10-25-13(a), the modification is accounted for prospectively as a termination of the existing contract and the creation of a new one. The new revenue standard also requires entities to record contract assets in certain circumstances (see Chapter 13), and these assets may still be recorded at the time of a contract modification.

Stakeholders have expressed two views on how to subsequently account for contract assets that exist before a contract is modified when a contract modification meets the conditions in ASC 606-10-25-13(a):

- *View A* — The terminated contract no longer exists. Accordingly, contract assets associated with the terminated contract should be written off to revenue (i.e., revenue should be reversed).
- *View B* — Existing contract assets should be carried forward to the new contract and realized as receivables are recognized (i.e., revenue is not reversed, leading to prospective accounting for the effects of the contract assets).

The TRG generally agreed with View B for three reasons. First, it better reflects the objective of ASC 606-10-25-13. Second, ASC 606-10-25-13(a) "explicitly states that the starting point for the determination [of the allocation in a modification] is the transaction price in the original contract *less* what had already been recognized as revenue."[1] Third, it is consistent with paragraph BC78 of ASU 2014-09, which notes that the intent of ASC 606-10-25-13(a) is to avoid adjusting revenue for performance obligations that have been satisfied (i.e., such modifications would be accounted for prospectively).

9.2.2.1 Blend-and-Extend Contract Modifications

Driving Discussion — Stand-Alone Selling Prices in Blend-and-Extend Contract Modifications

For blend-and-extend[2] (B&E) contract modifications, stakeholders have questioned how the payment terms affect the evaluation of the contract modification (i.e., whether the modification should be accounted for as a separate contract). In a typical B&E modification, the supplier and customer may renegotiate the contract to allow the customer to take advantage of lower commodity pricing while the supplier increases its future delivery portfolio. Under such circumstances, the customer and supplier agree to extend the contract term and "blend" the remaining original, higher contract rate with the lower market rate of the extension period for the remainder of the combined term. The supplier therefore defers the cash realization of some of the contract fair value that it would have received under the original contract terms until the extension period, at which time it will receive an amount that is greater than the market price for the extension-period deliveries as of the date of the modification.

[1] Quoted from paragraph 14 of TRG Agenda Paper 51.

[2] A common transaction in the power and utilities (P&U) industry, blend-and-extend refers to an agreement between an entity and a customer that are already in a contract to change the amount of consideration to be paid and extend the length of the contract term.

This is best illustrated by a simple example. Assume that a supplier and a customer enter into a fixed-volume, five-year forward sale of electricity at a fixed price of $50 per unit. Further assume that years 1 through 3 have passed and both parties have met all of their performance and payment obligations during that period. At the beginning of year 4, the customer approaches the supplier and asks for a two-year contract extension, stretching the remaining term to four years. Electricity prices have gone down since the original agreement was executed; as a result, a fixed price for the two-year extension period is $40 per unit based on forward market price curves that exist at the beginning of year 4. The customer would like to negotiate a lower rate now while agreeing to extend the term of the original deal.

The supplier and customer agree to a B&E contract modification. Under the modification, the $50-per-unit fixed price from the original contract with two years remaining is blended with the $40-per-unit fixed price for the two-year extension period. The resulting blended rate for the four remaining delivery years is $45 per unit.

There has been uncertainty about whether the supplier should compare (1) the total increase in the aggregated contract price with the total stand-alone selling price of the remaining goods or services or (2) the price the customer will pay for the additional goods or services (i.e., the $45-per-unit blended price paid for the goods or services delivered during the extension period) with the stand-alone selling price of those goods or services. In addition, the total transaction price may need to be reevaluated because the blending of the prices may create a significant financing component under the view that some of the consideration for the current goods or services is paid later as a result of the blending of the price for the remainder of the combined term.

The AICPA's P&U industry task force was unable to reach a consensus on whether a B&E contract modification should be accounted for as (1) a separate contract for the additional goods or services ("View A") or (2) the termination of an existing contract and the creation of a new contract ("View B"). The issue was discussed with the AICPA's revenue recognition working group but was ultimately elevated to a discussion with the FASB staff through the staff's technical inquiry process.

During that process, the FASB staff indicated that both views are acceptable but noted that View B is more consistent with the staff's interpretation of the contract modification guidance in the new revenue standard. The staff also indicated that entities will still need to assess whether B&E transactions include significant financing components; however, the staff noted that it did not think that every B&E contract modification inherently involves a financing. The feedback from the FASB staff will be reviewed by the AICPA P&U industry task force, discussed with the AICPA revenue recognition working group, and eventually included in the AICPA's P&U industry audit and accounting guide.

9.2.2.2 Modification and Discount for Low-Quality Products

ASC 606-10

Example 5 — Modification of a Contract for Goods

55-111 An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

[Case A omitted[3]]

Case B — Additional Products for a Price That Does Not Reflect the Standalone Selling Price

55-114 During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of $80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of $15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of $900 ($15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is $1,500 or $50 per product. That price comprises the agreed-upon price for the additional 30 products of $2,400, or $80 per product, less the credit of $900.

55-115 At the time of modification, the entity recognizes the $900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of $80 per product does not reflect the standalone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 606-10-25-12 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity applies the guidance in paragraph 606-10-25-13(a) and accounts for the modification as a termination of the original contract and the creation of a new contract.

55-116 Consequently, the amount recognized as revenue for each of the remaining products is a blended price of $93.33 {[($100 × 60 products not yet transferred under the original contract) + ($80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.

Driving Discussion — Stakeholder Questions About Example 5, Case B, in ASC 606

Stakeholders have raised questions about the previous example. The facts describe a contract modification in which an entity gives a customer a discount because goods and services previously delivered to the customer were determined to be of lower quality than that to which the parties had agreed. The example is designed to illustrate how an entity would apply the guidance in ASC 606-10-25-13(a), which describes a modification that would terminate the original contract and create a new one. In the absence of this example, a literal interpretation of the guidance in ASC 606-10-25-13(a) would require all of the consideration, inclusive of the discount negotiated in the modification for the 60 flawed products already delivered, to be recognized only when the undelivered products are delivered to the customer in the future. That is, the allocation of the remaining consideration of $7,500 (which is the sum of (1) the original 60 remaining products × $100 per product and (2) the additional 30 products × $50 per product) would result in the recognition of $83.33 for each of the remaining 90 products delivered. This is because as of the date of the modification, the 90 products (60 in the original contract and 30 in the modification) are distinct from the 60 products already delivered.

[3] Case A of Example 5 is reproduced in Section 9.2.1.

Specifically, stakeholders have questioned how to determine the appropriate accounting approach when a contract is modified and the selling price reflects both (1) compensation for poor-quality goods or services that have already been supplied to the customer and (2) a selling price for the additional goods or services that does not represent the stand-alone selling price as of the date of the contract modification. Generally, we believe that entities should carefully consider the facts and circumstances in a modification and appropriately consider whether there is a price concession or discount attributable to past performance that is similar to the price concession in the example above.

9.2.2.3 Additional Examples

ASC 606-10

Example 7 — Modification of a Services Contract

55-125 An entity enters into a three-year contract to clean a customer's offices on a weekly basis. The customer promises to pay \$100,000 per year. The standalone selling price of the services at contract inception is \$100,000 per year. The entity recognizes revenue of \$100,000 per year during the first 2 years of providing services. At the end of the second year, the contract is modified and the fee for the third year is reduced to \$80,000. In addition, the customer agrees to extend the contract for 3 additional years for consideration of \$200,000 payable in 3 equal annual installments of \$66,667 at the beginning of years 4, 5, and 6. After the modification, the contract has 4 years remaining in exchange for total consideration of \$280,000. The standalone selling price of the services at the beginning of the third year is \$80,000 per year. The entity's standalone selling price at the beginning of the third year, multiplied by the remaining number of years to provide services, is deemed to be an appropriate estimate of the standalone selling price of the multiyear contract (that is, the standalone selling price is 4 years × \$80,000 per year = \$320,000).

55-126 At contract inception, the entity assesses that each week of cleaning service is distinct in accordance with paragraph 606-10-25-19. Notwithstanding that each week of cleaning service is distinct, the entity accounts for the cleaning contract as a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the weekly cleaning services are a series of distinct services that are substantially the same and have the same pattern of transfer to the customer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

55-127 At the date of the modification, the entity assesses the remaining services to be provided and concludes that they are distinct. However, the amount of remaining consideration to be paid (\$280,000) does not reflect the standalone selling price of the services to be provided (\$320,000).

55-128 Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(a) as a termination of the original contract and the creation of a new contract with consideration of \$280,000 for 4 years of cleaning service. The entity recognizes revenue of \$70,000 per year (\$280,000 ÷ 4 years) as the services are provided over the remaining 4 years.

Construction Ahead — Update to Example 7

At the FASB's August 31, 2016, meeting, the Board discussed changes to ASC 606 related to this example, as identified in the Board's proposed ASU on technical corrections. See Chapter 19 for further details.

ASC 606-10

Example 8 — Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue

55-129 An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of $1 million and a bonus of $200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 606-10-25-27(b) because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

Transaction price	$ 1,000,000
Expected costs	700,000
Expected profit (30%)	$ 300,000

55-130 At contract inception, the entity excludes the $200,000 bonus from the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

55-131 The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress toward complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 percent of its performance obligation on the basis of costs incurred to date ($420,000) relative to total expected costs ($700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, the cumulative revenue and costs recognized for the first year are as follows:

Revenue	$ 600,000
Costs	420,000
Gross profit	$ 180,000

55-132 In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by $150,000 and $120,000, respectively. Total potential consideration after the modification is $1,350,000 ($1,150,000 fixed consideration + $200,000 completion bonus). In addition, the allowable time for achieving the $200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized in accordance with paragraph 606-10-32-11 and includes the $200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 606-10-25-19(b) and concludes (on the basis of the factors in paragraph 606-10-25-21) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

55-133 Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 606-10-25-13(b)). The entity updates its measure of progress and estimates that it has satisfied 51.2 percent of its performance obligation ($420,000 actual costs incurred ÷ $820,000 total expected costs). The entity recognizes additional revenue of $91,200 [(51.2 percent complete × $1,350,000 modified transaction price) – $600,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

ASC 606-10 (continued)

Example 9 — Unapproved Change in Scope and Price

55-134 An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

55-135 The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

9.2.3 Contract Modifications That Reduce the Scope of a Contract

The new revenue standard specifically states that a contract modification is a change in the scope or price of a contract. Therefore, a contract modification can be one that increases or decreases a contract's goods and services or its price. There can be situations in which part of a contract is terminated and the change would be a contract modification.

The Q&As below illustrate how to account for reductions in the scope of contracts.

Q&A 9-1 Contract Modification Resulting in a Reduction of Scope of a Contract

Question

How should an entity account for a contract modification that results in a **decrease** in scope (i.e., the removal from the contract of promised goods or services)?

Answer

Depending on whether the remaining goods or services in the existing contract are distinct from those transferred before the modification, ASC 606-10-25-13 requires an entity to account for such a modification as either (1) the termination of the existing contract and the creation of a new contract or (2) a cumulative catch-up adjustment to the existing contract.

The modification cannot be accounted for as a separate contract because the criterion in ASC 606-10-25-12(a) specifying an **increase** in the scope of the contract is not met.

Example 1

Entity Y enters into a contract with a customer to provide Product X and 12 months of services to be used in conjunction with Product X in return for consideration of $140; the services portion of the contract qualifies as a series in accordance with ASC 606-10-25-14(b). Product X and the services are each determined to be distinct, with consideration of $40 allocated to Product X (recognized on transfer of control of Product X) and consideration of $100 allocated to the services portion of the contract (recognized over the 12-month service period).

Six months after the start of the contract, the customer modifies the contract to reduce the level of service required. By the time of this modification, Y has already (1) recognized revenue of $40 for delivery of Product X, (2) recognized revenue of $50 for services provided to date, and (3) received payment from the customer of $110. Entity Y agrees to a reduction in price such that the customer will pay only $10 in addition to the payments already made.

Given that the remaining six months of service are distinct from both the delivery of Product X and those services provided in the first six months of the contract, this decrease in scope (and price) should be accounted for as a termination of the existing contract and the creation of a new contract as required by ASC 606-10-25-13(a), with $30 allocated to the services still to be provided (i.e., the $20 previously collected from the customer but not recognized as revenue plus the remaining $10 due under the modified contract).

Example 2

Entity X enters into a contract to produce a single large item of specialized machinery for a customer. Multiple components are used in the production of the specialized machinery, but they are significantly integrated so that X is using the goods as inputs to produce the combined output of the specialized machinery. Four months into the contract term, the customer decides to source a component of the project from an alternative source; X agrees to this contract modification, which reduces the contract scope.

Given that the remaining goods or services to be provided are not distinct from those already provided, ASC 606-10-25-13(b) requires X to (1) account for the contract modification as part of the existing contract and (2) recognize a cumulative catch-up adjustment to revenue at the time the modification occurs.

Refer to Example 8 in ASC 606-10-55-129 through 55-133 for an example of the calculation of a cumulative catch-up adjustment under ASC 606-10-25-13(b).

Q&A 9-2 Partial Termination of a Contract

An entity enters into a contract with a customer to provide specified services for a defined period at predetermined pricing. The service elements are distinct and meet the criteria in ASC 606-10-25-15 to be accounted for as a series, that is, a single performance obligation that is satisfied over time. The contract does not have an early termination provision (i.e., the contract does not allow the customer to terminate the contract before the end of the contract period and incur a penalty). Nevertheless, during the contract period, the customer negotiates with the entity to terminate portions of the contract. For example, at the end of year 1 of a five-year service contract, the customer negotiates with the entity to terminate years 4 and 5 of the contract but will continue to receive services for years 2 and 3. The customer agrees to pay a penalty to terminate part of the contract but will continue to pay the original agreed-upon rates for years 2 and 3.

Question

In the circumstances described, how should the entity account for the partial termination of the contract?

Answer

The partial termination described above should be accounted for as a contract modification in accordance with ASC 606-10-25-10 through 25-13. The partial termination meets the definition of a contract modification in ASC 606-10-25-10 because it changes the scope and price of the contract.

The modification does not meet the criteria in ASC 606-10-25-12 to be accounted for as a separate contract because it does not result in an *increase* in the scope of the contract. Because the remaining services in the series to be provided under the modified contract are distinct from the services provided before the partial termination, the modification would be accounted for as a termination of the existing contract and the creation of a new contract in accordance with ASC 606-10-25-13(a).

Example

Provider P has entered into an enforceable contract to deliver 25 hours of routine and recurring cleaning services every month to Customer C for five years at a fixed price of $1,000 per month (total transaction price of $60,000), which represents the stand-alone selling price for cleaning services at contract inception.

At the end of year 1 (i.e., year 1 has passed and both parties have met all of their performance and payment obligations during that period), the market for cleaning services has declined and the customer's need for cleaning services has changed. Customer C and P agree to reduce the remaining term of the contract to two years (i.e., terminate years 4 and 5 of the contract). The stand-alone selling price of the cleaning services is $750 per month on the date of the contract modification.

To compensate P for its lost value on years 4 and 5 of the contract when C would have to pay P at above-market rates, C agrees to pay a $6,000 penalty (i.e., 24 months in years 4 and 5 × $250 per month, the excess of the contract rate of $1,000 over the stand-alone selling price of $750 on the date of modification).

Provider P accounts for the contract as a series of distinct services with the same pattern of transfer to C in accordance with ASC 606-10-25-15 and, therefore, as a single performance obligation satisfied over time in accordance with ASC 606-10-25-27(a) (and ASC 606-10-55-5 and 55-6). Provider P uses an output method based on time elapsed to measure its progress toward complete satisfaction of its performance obligation.

Provider P should account for the partial termination as a contract modification in accordance with ASC 606-10-25-10 through 25-13. The criteria for accounting for a contract modification as a separate contract in ASC 606-10-25-12 are not met because the scope of the contract does not increase. Consequently, P should account for the modification in accordance with the guidance in ASC 606-10-25-13, the application of which would result in accounting for the modification as a termination of the old agreement and the creation of a new agreement.

Provider P should therefore account for the modification prospectively and recognize $30,000 (i.e., $12,000 per year under the original terms for years 2 and 3 plus the $6,000 compensation payment) over the remaining revised contract period of two years.

9.3 Reassessing Step 1 Upon a Contract Modification

Contract modifications tend to occur because despite all of the planning that an entity and its customer can do, unforeseen challenges can cause business needs to change. A modification could change the terms of a contract so significantly that the modified contract does not resemble the original contract. Once a contract is modified, a company might question whether the contract still meets the contract existence criteria in step 1 (see Chapter 4). Consider the Q&A below.

Q&A 9-3 Contract Modification — Requirement to Reconsider Whether the Contract Should Be Accounted for Under ASC 606

Question

If a contract with a customer that has previously met the criteria in ASC 606-10-25-1 is subsequently modified, is an entity always required to reassess whether the contract meets the criteria in ASC 606-10-25-1?

Answer

No. ASC 606-10-25-5 states that an entity should reassess the criteria in ASC 606-10-25-1 only if "there is an indication of a significant change in facts and circumstances." The nature of a contract modification and the circumstances in which it is made will determine whether it should be deemed to reflect a significant change in facts and circumstances as contemplated in ASC 606-10-25-5. For example, a contract modification may sometimes be caused by a significant deterioration in the customer's ability to pay (i.e., a change in the expectation of collectibility since contract inception), which is included in ASC 606-10-25-5 as an example of a circumstance necessitating reassessment of the ASC 606-10-25-1 criteria.

If a reassessment is deemed necessary and leads to a conclusion that one or more of the criteria in ASC 606-10-25-1 are not met (e.g., if it is no longer probable that the entity will collect the consideration to which it will be entitled), the contract should subsequently be accounted for in accordance with ASC 606-10-25-7.

The required accounting for modifications of contracts that continue to meet the criteria in ASC 606-10-25-1 is described in ASC 606-10-25-10 through 25-13.

9.4 Change in Transaction Price After a Contract Modification

The sections above address situations involving a contract modification and a change in the amount of consideration in the contract. In those situations, the change in the amount of consideration occurred at the time of the modification and was a result of the modification. However, a contract's consideration could also change when an entity reassesses the variable consideration of a contract at the end of a reporting period in accordance with ASC 606-10-32-14. This reassessment is required in all reporting periods for all contracts, including those that have been modified.

For example, suppose that Company A, on the basis of its initial judgment, determines that it is constrained from recognizing variable consideration as revenue at the beginning of a contract. Further assume that after a modification occurs, A performs a reassessment of the variable consideration and determines that it is no longer constrained. As a result of this reassessment, A needs to determine how to allocate the variable consideration to performance obligations that have not been satisfied and possibly even to those that were satisfied before the modification.

To address a change in variable consideration after a modification, the FASB provides the following guidance, which is intended to align with the guidance on a change in the variable consideration of a contract that has not been modified:

ASC 606-10

32-45 An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).

b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

The example below, which is reproduced from the new revenue standard, illustrates this concept.

ASC 606-10

Example 6 — Change in the Transaction Price after a Contract Modification

55-117 On July 1, 20X0, an entity promises to transfer two distinct products to a customer. Product X transfers to the customer at contract inception and Product Y transfers on March 31, 20X1. The consideration promised by the customer includes fixed consideration of $1,000 and variable consideration that is estimated to be $200. The entity includes its estimate of variable consideration in the transaction price because it concludes that it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved.

55-118 The transaction price of $1,200 is allocated equally to the performance obligation for Product X and the performance obligation for Product Y. This is because both products have the same standalone selling prices and the variable consideration does not meet the criteria in paragraph 606-10-32-40 that requires allocation of the variable consideration to one but not both of the performance obligations.

55-119 When Product X transfers to the customer at contract inception, the entity recognizes revenue of $600.

55-120 On November 30, 20X0, the scope of the contract is modified to include the promise to transfer Product Z (in addition to the undelivered Product Y) to the customer on June 30, 20X1, and the price of the contract is increased by $300 (fixed consideration), which does not represent the standalone selling price of Product Z. The standalone selling price of Product Z is the same as the standalone selling prices of Products X and Y.

55-121 The entity accounts for the modification as if it were the termination of the existing contract and the creation of a new contract. This is because the remaining Products Y and Z are distinct from Product X, which had transferred to the customer before the modification, and the promised consideration for the additional Product Z does not represent its standalone selling price. Consequently, in accordance with paragraph 606-10-25-13(a), the consideration to be allocated to the remaining performance obligations comprises the consideration that had been allocated to the performance obligation for Product Y (which is measured at an allocated transaction price amount of $600) and the consideration promised in the modification (fixed consideration of $300). The transaction price for the modified contract is $900, and that amount is allocated equally to the performance obligation for Product Y and the performance obligation for Product Z (that is, $450 is allocated to each performance obligation).

ASC 606-10 (continued)

55-122 After the modification but before the delivery of Products Y and Z, the entity revises its estimate of the amount of variable consideration to which it expects to be entitled to $240 (rather than the previous estimate of $200). The entity concludes that the change in estimate of the variable consideration can be included in the transaction price because it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved. Even though the modification was accounted for as if it were the termination of the existing contract and the creation of a new contract in accordance with paragraph 606-10-25-13(a), the increase in the transaction price of $40 is attributable to variable consideration promised before the modification. Therefore, in accordance with paragraph 606-10-32-45, the change in the transaction price is allocated to the performance obligations for Product X and Product Y on the same basis as at contract inception. Consequently, the entity recognizes revenue of $20 for Product X in the period in which the change in the transaction price occurs. Because Product Y had not transferred to the customer before the contract modification, the change in the transaction price that is attributable to Product Y is allocated to the remaining performance obligations at the time of the contract modification. This is consistent with the accounting that would have been required by paragraph 606-10-25-13(a) if that amount of variable consideration had been estimated and included in the transaction price at the time of the contract modification.

55-123 The entity also allocates the $20 increase in the transaction price for the modified contract equally to the performance obligations for Product Y and Product Z. This is because the products have the same standalone selling prices and the variable consideration does not meet the criteria in paragraph 606-10-32-40 that require allocation of the variable consideration to one but not both of the performance obligations. Consequently, the amount of the transaction price allocated to the performance obligations for Product Y and Product Z increases by $10 to $460 each.

55-124 On March 31, 20X1, Product Y is transferred to the customer, and the entity recognizes revenue of $460. On June 30, 20X1, Product Z is transferred to the customer, and the entity recognizes revenue of $460.

Chapter 10 — Principal-Versus-Agent Considerations

10.1 General Considerations

For an entity, deciding whether the nature of its promise is to transfer goods or services to the customer itself (as a principal) or to arrange for goods or services to be provided by another party (as an agent) is an important determination because the conclusion the entity reaches can significantly affect the amount of revenue recognized. Whereas a principal of a performance obligation will recognize revenue at the gross amount it is entitled to from its customer, an agent will present revenue at the net amount retained. Like current U.S. GAAP, the new revenue standard requires a degree of judgment to be used in the assessment. Current guidance relies on a risks-and-rewards model for determining how and when to recognize revenue, as it does for determining whether an entity is a principal or an agent in a transaction. In contrast, the new revenue standard is focused on recognizing revenue as an entity transfers control of a good or service to a customer. This change from a risks-and-rewards model to a control model will also affect how an entity evaluates its position in a transaction as either a principal or an agent. The new revenue standard provides that an entity is a principal in a transaction if it controls the specified goods or services before they are transferred to the customer. Like current U.S. GAAP, the new revenue standard provides some indicators to help an entity determine whether it is a principal. However, unlike the indicators in current U.S. GAAP, which are used to assess whether an entity has risks and rewards that are consistent with those of a principal in a transaction, the indicators in the new revenue standard help an entity assess whether it controls the underlying goods or services before they are transferred to the customer. See Section 10.1.2 below for further details of the differences.

Stakeholders identified significant implementation questions arising from the original guidance in ASU 2014-09, many of which were discussed by the TRG. On March 17, 2016, the FASB issued ASU 2016-08,[1] which modifies the new revenue standard to address concerns raised by these stakeholders. ASU 2016-08 will become effective at the same time the new revenue standard becomes effective.

The remainder of this chapter discusses the application of ASU 2014-09 as modified by ASU 2016-08.

10.1.1 Identifying the Goods or Services

ASC 606-10

55-36 When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

55-36A To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])
b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

[1] The IASB issued consistent amendments to IFRS 15 in its final standard *Clarifications to IFRS 15*, which was issued April 2016.

The first step in the evaluation of whether an entity is acting as a principal or as an agent when another party is involved in providing goods or services to a customer is to identify the goods or services that will be transferred to the customer (i.e., the "specified goods or services" referred to in ASC 606-10-55-36A). In the amendments in ASU 2016-08, the FASB confirmed that the unit of account for evaluating whether an entity is acting as a principal or as an agent is not at the contract level. Rather, the principal-versus-agent analysis is performed for each specified distinct good or service (or distinct bundle of goods or services) that will be transferred to the customer. Accordingly, an entity could be a principal for certain aspects of a contract with a customer and an agent for others.

The unit of account to be used in the first step of the principal-versus-agent analysis could be described as being at the performance obligation level. Consequently, this part of the analysis could be performed as part of step 2 of the new revenue model. However, the new revenue standard does not refer to the analysis as being conducted at the performance obligation level because the performance obligation of an agent is to arrange for another entity to transfer the specified goods or services to the customer. For an entity to determine whether it controls promised goods or services before they are transferred to a customer, it must first identify the specific goods or services that will be transferred to the customer. However, the notion of aggregating goods or services that are not distinct into performance obligations (i.e., a distinct bundle of goods or services) will apply to identifying the unit of account used in the evaluation of whether an entity is acting as a principal or as an agent.

10.1.2 Determining Whether the Entity Controls the Goods or Services Before They Are Transferred to the Customer

Changing Lanes — Comparison of Indicators in the Principal-Versus-Agent Analysis Under Current and New Revenue Guidance

As mentioned in Section 10.1 above, the manner of determining whether an entity is a principal or an agent under current U.S. GAAP differs from how that determination is made under the new revenue standard. The following table lists the indicators of a principal from both the current and new revenue guidance:

Purpose of Indicators: To identify whether the entity has risks and rewards of the principal (ASC 605-45)	Purpose of Indicators: To determine whether the entity controls the goods or services before they are transferred to the customer (ASC 606)
The entity is the primary obligor.	The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
The entity has general inventory risk before the customer order is placed or upon customer return.	The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return).
The entity has latitude in establishing the price.	The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases.

(Table continued)

Purpose of Indicators: To identify whether the entity has risks and rewards of the principal (ASC 605-45)	Purpose of Indicators: To determine whether the entity controls the goods or services before they are transferred to the customer (ASC 606)
The entity changes the product or performs part of the service.	Indicator not used in ASC 606.
The entity has discretion in supplier selection.	Indicator not used in ASC 606.
The entity is involved in the determination of product or service specifications.	Indicator not used in ASC 606.
The entity has physical loss inventory risk after the customer order or during shipping.	Indicator not used in ASC 606.
The entity has credit risk.	Indicator not used in ASC 606.

As the table shows, the two sets of indicators for when the entity is acting as a principal are worded similarly, although there are fewer indicators in the new standard and there are no indicators of when an entity is acting as an agent. This might lead an entity to believe that there is no change between the two sets of guidance. However, the overall concept of recognizing revenue changes from a focus on risks and rewards under current guidance to transfer of control under the new revenue standard, and this change affects how the indicators are evaluated. In general, an entity applying current U.S. GAAP is asked to consider whether it (1) earned revenue from the sale of goods or services, which would mean that it acted as a principal, or (2) earned a commission from a transaction, and therefore acted as an agent. Under the new revenue standard, which focuses on transfer of control, an entity is asked to consider whether it controlled the goods or services it transferred to determine whether it acted as a principal or as an agent. This different application of the indicators is important for entities to understand because it can result in different outcomes.

Another difference between current U.S. GAAP and the new revenue standard is how the indicators are weighted. Under current U.S. GAAP, being the primary obligor and having general inventory risk are both strong indicators that an entity is acting as a principal. However, the new revenue standard specifically notes that the indicators "may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts."

In a manner similar to how an entity performs the principal-versus-agent analysis under current U.S. GAAP, an entity applying the new revenue standard will need to use judgment to determine whether it is acting as a principal or as an agent. The remainder of Chapter 10 discusses how an entity might exercise this judgment.

10.2 Determining Whether an Entity Is Acting as a Principal

The new revenue standard's core principle focuses on the transfer of control of goods or services to a customer. When developing the framework for evaluating whether an entity's performance obligation is to transfer goods or services to a customer or to arrange for another party to provide those goods or services to a customer, the FASB and IASB observed that an entity would be a principal if it controlled those goods or services before they were transferred to the customer. This observation is reflected in the following guidance:

ASC 606-10

55-37 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

Often, it will be clear that an entity controls a good before it is transferred to a customer because the entity acquired the good (i.e., obtained control) from a third party before transfer of the good to the customer. These situations will often involve an element of inventory risk that is assumed while the good is in the entity's control. There may also be instances in which an entity controls a right to a service (e.g., a voucher) and passes it on to a customer. In these instances, the entity is not providing the service to which the voucher entitles a customer, but the entity may control the right to the service by controlling the voucher before it is transferred to the customer. The entity can redeem the voucher for the service, or it can transfer the right to the service to a customer by transferring the voucher. Alternatively, an entity may integrate a good or service provided by a third party into another good or service controlled by the entity. The entity's performance obligation may be to transfer the distinct bundle of goods or services (that includes the third party's good or service) to the customer. An entity would need to obtain control of the third party's good or service before integrating the good or service with other goods or services promised to the customer. These three scenarios are described in ASC 606-10-55-37A below.

ASC 606-10

55-37A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.
b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

In the above situations, it may be clear that the entity controls the goods or services before they are transferred to the customer. This may even be the case if the entity does not fulfill the promise itself but directs a third party to fulfill the obligation on its behalf. In other situations, however, it may not be clear whether the entity does in fact obtain control of the goods or services provided by a third party before they are transferred to the customer. In these circumstances, the entity will need to consider the indicators in ASU 2016-08 when evaluating whether it is acting as a principal. Those indicators are listed and explained in ASC 606-10-55-39 and 55-39A as follows:

ASC 606-10

55-39 Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers. . . .

55-39A The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

As shown in the table in Section 10.1.2 above, only three indicators of control are included in the new revenue standard (compared with eight indicators of a principal in ASC 605-45). Assessment of the first two indicators under the new revenue standard (primary responsibility and inventory risk) is likely to be similar to the assessment of the primary obligor and general inventory risk indicators under current U.S. GAAP. In addition, discretion in establishing pricing is also an indicator for gross reporting under current U.S. GAAP. However, under current U.S. GAAP, primary obligor and general inventory risk are strong indicators. As a result, if an entity exhibits one of these, it is likely to conclude under current U.S. GAAP that it is the principal in the transaction. However, the indicators under the new revenue standard may be more or less relevant in each fact pattern. Consequently, an entity that relied on either being the primary obligor or having general inventory risk to support the presentation conclusions under current U.S. GAAP will still need to determine whether it controls the underlying goods or services before they are transferred to the customer by considering how the control indicators should be evaluated under the facts and circumstances of the entity's arrangements.

It is also important to note that none of the other indicators of whether an entity is acting as a principal or an agent that are currently in ASC 605-45 were included as an indicator that the entity controls the goods or services before they are transferred to the customer. The boards considered whether these or other indicators could help entities use judgment. For example, the boards considered, but ultimately rejected, including exposure to credit risk as an indicator that the entity controls the goods or services before they are transferred to the customer. The boards observed that exposure to credit risk is not a helpful indicator since both a principal and an agent could be exposed to credit risk in certain circumstances. The boards also considered including an indicator related to the form of consideration (i.e., whether the consideration is in the form of a commission), but they ultimately concluded that the form of consideration is not indicative of whether the entity is acting as a principal.

The following implementation guidance from the new revenue standard will help an entity determine whether it is acting as a principal in a contract:

ASC 606-10

Example 46 — Promise to Provide Goods or Services (Entity Is a Principal)

55-320 An entity enters into a contract with a customer for equipment with unique specifications. The entity and the customer develop the specifications for the equipment, which the entity communicates to a supplier that the entity contracts with to manufacture the equipment. The entity also arranges to have the supplier deliver the equipment directly to the customer. Upon delivery of the equipment to the customer, the terms of the contract require the entity to pay the supplier the price agreed to by the entity and the supplier for manufacturing the equipment.

55-321 The entity and the customer negotiate the selling price, and the entity invoices the customer for the agreed-upon price with 30-day payment terms. The entity's profit is based on the difference between the sales price negotiated with the customer and the price charged by the supplier.

55-322 The contract between the entity and the customer requires the customer to seek remedies for defects in the equipment from the supplier under the supplier's warranty. However, the entity is responsible for any corrections to the equipment required resulting from errors in specifications.

55-323 To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer. . . .

55-323A The entity concludes that it has promised to provide the customer with specialized equipment designed by the entity. Although the entity has subcontracted the manufacturing of the equipment to the supplier, the entity concludes that the design and manufacturing of the equipment are not distinct because they are not separately identifiable (that is, there is a single performance obligation). The entity is responsible for the overall management of the contract (for example, by ensuring that the manufacturing service conforms to the specifications) and thus provides a significant service of integrating those items into the combined output — the specialized equipment — for which the customer has contracted. In addition, those activities are highly interrelated. If necessary modifications to the specifications are identified as the equipment is manufactured, the entity is responsible for developing and communicating revisions to the supplier and for ensuring that any associated rework required conforms with the revised specifications. Accordingly, the entity identifies the specified good to be provided to the customer as the specialized equipment.

ASC 606-10 (continued)

55-323B The entity concludes that it controls the specialized equipment before that equipment is transferred to the customer (see paragraph 606-10-55-37A(c)). The entity provides the significant integration service necessary to produce the specialized equipment and, therefore, controls the specialized equipment before it is transferred to the customer. The entity directs the use of the supplier's manufacturing service as an input in creating the combined output that is the specialized equipment. In reaching the conclusion that it controls the specialized equipment before that equipment is transferred to the customer, the entity also observes that even though the supplier delivers the specialized equipment to the customer, the supplier has no ability to direct its use (that is, the terms of the contract between the entity and the supplier preclude the supplier from using the specialized equipment for another purpose or directing that equipment to another customer). The entity also obtains the remaining benefits from the specialized equipment by being entitled to the consideration in the contract from the customer.

55-324 Thus, the entity concludes that it is a principal in the transaction. The entity does not consider the indicators in paragraph 606-10-55-39 because the evaluation above is conclusive without consideration of the indicators. The entity recognizes revenue in the gross amount of consideration to which it is entitled from the customer in exchange for the specialized equipment.

Example 46A — Promise to Provide Goods or Services (Entity Is a Principal)

55-324A An entity enters into a contract with a customer to provide office maintenance services. The entity and the customer define and agree on the scope of the services and negotiate the price. The entity is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract. The entity invoices the customer for the agreed-upon price on a monthly basis with 10-day payment terms.

55-324B The entity regularly engages third-party service providers to provide office maintenance services to its customers. When the entity obtains a contract from a customer, the entity enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer. The payment terms in the contracts with the service providers generally are aligned with the payment terms in the entity's contracts with customers. However, the entity is obliged to pay the service provider even if the customer fails to pay.

55-324C To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

55-324D The entity observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted and that no other goods or services are promised to the customer. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that the entity has not agreed to provide. Therefore, the right to office maintenance services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.

ASC 606-10 (continued)

55-324E The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph 606-10-55-37A(b)). In addition, the entity concludes that the following indicators in paragraph 606-10-55-39 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:

a. The entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (that is, the entity is responsible for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).
b. The entity has discretion in setting the price for the services to the customer.

55-324F The entity observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Thus, the entity has mitigated its inventory risk with respect to the office maintenance services. Nonetheless, the entity concludes that it controls the office maintenance services before they are provided to the customer on the basis of the evidence in paragraph 606-10-55-324E.

55-324G Thus, the entity is a principal in the transaction and recognizes revenue in the amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

Example 47 — Promise to Provide Goods or Services (Entity Is a Principal)

55-325 An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance.

55-326 The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased.

55-327 The entity also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

55-328 To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer. . . .

55-328A The entity concludes that with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers (see paragraph 606-10-55-37A(a)). Consequently, the entity determines that the specified good or service to be provided to its customer is that right (to a seat on a specific flight) that the entity controls. The entity observes that no other goods or services are promised to the customer.

ASC 606-10 (continued)

55-328B The entity controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and, if so, which contract it will fulfill. The entity also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

55-328C The indicators in paragraph 606-10-55-39(b) through (c) also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer. The entity has inventory risk with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favorable price for the ticket. The entity also establishes the price that the customer will pay for the specified ticket.

55-329 Thus, the entity concludes that it is a principal in the transactions with customers. The entity recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

10.3 Determining Whether an Entity Is Acting as an Agent

If an entity concludes that it does not obtain control of a good or service before that good or service is transferred to a customer, the entity is acting as an agent. That is, the entity's performance obligation is to arrange for another party to transfer the good or service to the customer. As an agent, the entity will recognize as revenue the commission or fee it earns when or as it satisfies its performance obligation of arranging for the specified goods or services to be provided by another party. This guidance is articulated in ASC 606-10-55-38 as follows:

ASC 606-10

55-38 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

The following implementation guidance from the new revenue standard will help an entity determine whether it is acting as an agent in a contract:

ASC 606-10

Example 45 — Arranging for the Provision of Goods or Services (Entity Is an Agent)

55-317 An entity operates a website that enables customers to purchase goods from a range of suppliers who deliver the goods directly to the customers. Under the terms of the entity's contracts with suppliers, when a good is purchased via the website, the entity is entitled to a commission that is equal to 10 percent of the sales price. The entity's website facilitates payment between the supplier and the customer at prices that are set by the supplier. The entity requires payment from customers before orders are processed, and all orders are nonrefundable. The entity has no further obligations to the customer after arranging for the products to be provided to the customer.

ASC 606-10 (continued)

55-318 To determine whether the entity's performance obligation is to provide the specified goods itself (that is, the entity is a principal) or to arrange for those goods to be provided by the supplier (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer. . . .

55-318A The website operated by the entity is a marketplace in which suppliers offer their goods and customers purchase the goods that are offered by the suppliers. Accordingly, the entity observes that the specified goods to be provided to customers that use the website are the goods provided by the suppliers, and no other goods or services are promised to customers by the entity.

55-318B The entity concludes that it does not control the specified goods before they are transferred to customers that order goods using the website. The entity does not at any time have the ability to direct the use of the goods transferred to customers. For example, it cannot direct the goods to parties other than the customer or prevent the supplier from transferring those goods to the customer. The entity does not control the suppliers' inventory of goods used to fulfill the orders placed by customers using the website.

55-318C As part of reaching that conclusion, the entity considers the following indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control the specified goods before they are transferred to the customers.

a. The supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. The entity is neither obliged to provide the goods if the supplier fails to transfer the goods to the customer nor responsible for the acceptability of the goods.
b. The entity does not take inventory risk at any time before or after the goods are transferred to the customer. The entity does not commit to obtain the goods from the supplier before the goods are purchased by the customer and does not accept responsibility for any damaged or returned goods.
c. The entity does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.

55-319 Consequently, the entity concludes that it is an agent and its performance obligation is to arrange for the provision of goods by the supplier. When the entity satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), the entity recognizes revenue in the amount of the commission to which it is entitled.

ASC 606-10

Example 48 — Arranging for the Provision of Goods or Services (Entity Is an Agent)

55-330 An entity sells vouchers that entitle customers to future meals at specified restaurants, and the sales price of the voucher provides the customer with a significant discount when compared with the normal selling prices of the meals (for example, a customer pays $100 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost $200). The entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only as they are requested by the customers. The entity sells the vouchers through its website, and the vouchers are nonrefundable.

ASC 606-10 (continued)

55-331 The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers. Under the terms of its contracts with the restaurants, the entity is entitled to 30 percent of the voucher price when it sells the voucher.

55-332 The entity also assists the customers in resolving complaints about the meals and has a buyer satisfaction program. However, the restaurant is responsible for fulfilling obligations associated with the voucher, including remedies to a customer for dissatisfaction with the service.

55-333 To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls the specified good or service before that good or service is transferred to the customer. . . .

55-333A A customer obtains a voucher for the restaurant that it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf as described in the indicator in paragraph 606-10-55-39(a). Therefore, the entity observes that the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant or restaurants, which the customer purchases and then can use itself or transfer to another person. The entity also observes that no other goods or services (other than the vouchers) are promised to the customers.

55-333B The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:

a. The vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers.
b. The entity neither purchases nor commits itself to purchase vouchers before they are sold to customers. The entity also has no responsibility to accept any returned vouchers. Therefore, the entity does not have inventory risk with respect to the vouchers as described in the indicator in paragraph 606-10-55-39(b).

55-334 Thus, the entity concludes that it is an agent in the arrangement with respect to the vouchers. The entity recognizes revenue in the net amount of consideration to which the entity will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 30 percent commission it is entitled to upon the sale of each voucher.

10.4 Contracts in Which the Entity Is a Principal and an Agent

As discussed in Section 10.1.1 above, an entity must determine whether it is a principal or an agent at what can effectively be described as the performance obligation level, not the contract level. Therefore, in some contracts, an entity could have both performance obligations to arrange for goods or services to be provided by another entity (i.e., the entity is acting as an agent) and performance obligations to transfer goods or services to the customer itself (i.e., the entity is acting as a principal). Consider the following example from the new revenue standard:

ASC 606-10

Example 48A — Entity Is a Principal and an Agent in the Same Contract

55-334A An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, such as interviewing candidates and performing background checks. As part of the contract with a customer, the customer agrees to obtain a license to access a third party's database of information on potential recruits. The entity arranges for this license with the third party, but the customer contracts directly with the database provider for the license. The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer. The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service down-time or other technical issues.

55-334B To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer and assesses whether it controls those goods or services before they are transferred to the customer.

55-334C For the purpose of this Example, it is assumed that the entity concludes that its recruitment services and the database access license are each distinct on the basis of its assessment of the guidance in paragraphs 606-10-25-19 through 25-22. Accordingly, there are two specified goods or services to be provided to the customer — access to the third-party's database and recruitment services.

55-334D The entity concludes that it does not control the access to the database before it is provided to the customer. The entity does not at any time have the ability to direct the use of the license because the customer contracts for the license directly with the database provider. The entity does not control access to the provider's database — it cannot, for example, grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

55-334E As part of reaching that conclusion, the entity also considers the indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer.

a. The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).
b. The entity does not have inventory risk because it does not purchase or commit to purchase the database access before the customer contracts for database access directly with the database provider.
c. The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

55-334F Thus, the entity concludes that it is an agent in relation to the third-party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer.

In the example above, an important part of the fact pattern is that the entity has no further obligations to the customer after arranging for the products to be provided to the customer. If this is not the case (e.g., because the entity would be responsible to the customer if the products were faulty and would accept returns), the analysis could be different.

10.5 Other Considerations

The sections below include (1) Q&As that explain how entities should present revenue for specific transactions in their financial statements and (2) a discussion of recent developments. Some of the topics addressed have been discussed by the TRG.

10.5.1 Change in the Nature of the Customer and Vendor Relationship

Sometimes, an entity may contractually and legally transfer its obligations to satisfy some or all of its promises under a contract with a customer. This situation is discussed in ASC 606-10-55-40.

ASC 606-10

55-40 If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (that is, the entity is no longer acting as the principal), the entity should not recognize revenue for that performance obligation. Instead, the entity should evaluate whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether the entity is acting as an agent).

An entity that was initially the principal in a transaction should perform a careful analysis of its performance obligation before concluding that it is no longer primarily responsible for fulfilling its promise under the contract. A customer would most likely need to agree to ceding the contract to another party and would look to that third party as the entity that is primarily responsible for the fulfillment of the contract.

10.5.2 Presentation of Sales Taxes and Similar Taxes Collected From Customers

Under step 3 of the new revenue standard (see Chapter 6), the transaction price is the "amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties." Stakeholders have questioned whether sales taxes and similar taxes ("sales taxes") should be excluded from the transaction price when such taxes are collected on behalf of tax authorities.

Further, the new revenue standard's guidance on assessing whether an entity is a principal or an agent in a transaction is relevant to the assessment of whether sales taxes should be presented gross or net within revenue. The analysis is further complicated by the sales tax regulations in each tax jurisdiction (which would include all taxation levels in both domestic and foreign governmental jurisdictions), especially for entities that operate in a significant number of jurisdictions.

ASC 606-10

32-2A An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

The FASB decided to provide in ASU 2016-12[2] a practical expedient (codified in ASC 606-10-32-2A) that permits entities to exclude from the transaction price all sales taxes that are assessed by a governmental authority and that are "imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and

[2] The IASB did not amend IFRS 15 for this practical expedient. For a summary of differences between ASC 606 and IFRS 15, see Appendix A.

some excise taxes).” However, such an accounting policy election does not apply to taxes assessed on “an entity’s total gross receipts or imposed during the inventory procurement process.” An entity that elects to exclude sales taxes is required to provide the accounting policy disclosures in ASC 235-10-50-1 through 50-6. See Chapter 14 on disclosure.

The guidance aligns the scope of sales taxes in the new revenue standard with that in ASC 605-45-15-2(e) under current revenue guidance. Further, an entity that does not elect to present all sales taxes on a net basis would be required to assess, for every tax jurisdiction, whether it is a principal or an agent in the sales tax transaction and would present sales taxes on a gross basis if it is a principal in the jurisdiction and on a net basis if it is an agent.

10.5.3 Income Tax Withholdings

Q&A 10-1 Income Tax Withheld in a Different Country

Company X performs consulting services for Company C, which is located in a different country from X. Company C withholds 20 percent of X’s fee as a local income tax withholding and transmits this amount to its local government on behalf of X (X retains the primary responsibility to pay the tax in C’s tax jurisdiction). Company C pays the remaining 80 percent balance to X. The countries do not have a tax treaty, and X is not required to file a tax return in C’s country. Company X was fully aware that the 20 percent income tax would be withheld in C’s country when it agreed to perform the consulting services for C.

Question

If X’s fee is $100 and C remits $80 to X and $20 to the local government, does X have revenue of $100 and tax expense of $20 or net revenue of $80?

Answer

Company X is the principal in providing the consulting services to C. Company X also has the primary responsibility to pay the tax in C’s tax jurisdiction, and C is simply paying the tax on X’s behalf (acting as a collection agent). Consequently, X should recognize revenue in the gross amount of consideration to which it expects to be entitled in exchange for those services and should therefore report revenue of $100 and income tax expense of $20.

Company X is not eligible for the practical expedient in ASC 606-10-32-2A in this instance because it involves a withholding of income tax, not sales tax. See Section 10.5.2 for further discussion of the sales tax practical expedient in ASC 606-10-32-2A.

10.5.4 Shipping and Handling Costs

Q&A 10-2 Presentation of Shipping and Handling Costs Billed to Customers

Many vendors charge customers for shipping and handling of goods. Shipping costs include costs incurred to move the product from the seller’s place of business to the buyer’s designated location and include payments to third-party shippers. But they may also be costs incurred directly by the seller (e.g., salaries and overheads related to the activities to prepare the goods for shipment). Handling costs include costs incurred to store, move, and prepare the products for shipment. Generally, handling costs are incurred from when the product is removed from finished-goods inventories to when the product is provided to the shipper and may include an allocation of internal overhead.

Some vendors charge customers a separate fee for shipping and handling costs. Alternatively, shipping and handling might be included in the price of the product. In some cases, the separate fee may be a standard amount that does not necessarily correlate directly with the costs incurred for the specific shipment. In other cases, the separate fee may be a direct reimbursement for shipping, and any direct incremental handling costs incurred or may include a margin on top of those costs.

Question

Company S sells goods to a customer and bills the customer for shipping and handling costs. How should S present the amounts billed for shipping and handling in profit or loss?

Answer

ASU 2016-10 provided a practical expedient in ASC 606-10-25-18B that permits presentation of shipping and handling costs that occur after control of the promised goods or services transfer to the customer as fulfillment costs. That is, that activity does not need to be identified as a promised good or service and a potential performance obligation. If an entity does not avail itself of the aforementioned practical expedient, then the appropriate presentation of amounts billed to a customer for shipping and handling will depend on an analysis of the principal-versus-agent considerations in ASC 606 related to shipping and handling services. If control of the goods transfers on receipt by the customer (e.g., on "free on board" (FOB) destination), the vendor will generally be considered to be the principal in the shipping and handling service. If, however, control of the goods transfers when the goods are shipped, the vendor will need to determine whether it is the principal or agent with respect to the shipping service.

If, after consideration of the requirements in ASC 606-10-55-36 through 55-40, S determines that it is responsible for shipping and handling as a principal, then all amounts billed to a customer in a sale transaction related to shipping and handling represent revenues earned for the goods provided (and the shipping services rendered, if the shipping service represents a distinct performance obligation) and will be presented as revenue.

However, if S considers the requirements of ASC 606-10-55-36 through 55-40 and determines that it is not responsible to the customer for shipping but is instead acting merely as the buyer's agent in arranging for a third party to provide shipping services to the buyer, then S should not report the amount charged by that third party for shipping as its own revenue. Instead, S should report as revenue only the commission it has received (if any) for arranging shipping, which is the excess of (1) any amounts charged to the customer for shipping by S over (2) any amounts paid to the third party for those services.

10.5.5 Revenue Equal to Costs

Q&A 10-3 Offsetting Revenue and Expenses When Goods and Services Are Sold at Cost

An entity determines, in accordance with ASC 606-10-55-36 through 55-40, that it provides goods, services, or both as a principal. It sells some goods and services to third parties at an amount equal to the cost of the goods and services.

Question

Is the entity permitted to present the associated revenues and expenses on a net basis?

Answer

No. When an entity has determined, after considering the requirements of ASC 606-10-55-36 through 55-40, that it acts as a principal in the sale of goods, services, or both, it should recognize revenue in the gross amount to which it is entitled. The practice of selling goods or providing services at an amount equal to cost does not mean that the revenue should be presented as a cost reimbursement. Revenue and expenses should, therefore, be presented gross.

For additional information, see Q&A 10-5.

10.5.6 Royalty Considerations

Q&A 10-4 Royalty Payments

Entity A has agreed to pay a royalty to Entity B for the use of the intellectual property rights that A requires to make sales to its customers. The royalty is specified as a percentage of gross proceeds from A's sales to its customers less certain contractually defined costs. Entity A is the principal in sales transactions with its customers (i.e., it must provide the goods and services itself and does not act as an agent for Entity B).

Question

In A's financial statements, should the royalty payments be netted against revenue or recognized as a cost of fulfilling the contract?

Answer

Because A is the principal in sales transactions with its customers, it should recognize its revenue on a gross basis and the royalty as a cost of fulfilling the contract.

For guidance on accounting for the costs of fulfilling a contract, including whether such costs should be capitalized or expensed, see ASC 340-40, as discussed in Chapter 12.

10.5.7 Shared Commissions

Q&A 10-5 Offsetting Revenue and Expenses for Shared Commissions

Company A has signed a contract with an insurance company under which it receives a commission for every policy it sells on behalf of the insurance company. Company A contracts with individual financial advisers to sell these insurance policies and agrees to split the commission evenly with the financial advisers. Company A provides administrative facilities and office space to the financial advisers. The insurance company is aware of the arrangements between A and the financial advisers, but its contractual relationship is with A, and A is responsible for providing the service to the insurance company. The insurance company pays the full commission to A, which then pays half of the commission to the financial adviser that sold the policy.

Company A has determined that it is acting as a principal in this arrangement, in accordance with ASC 606-10-55-36 through 55-40.

Question

Is A permitted to offset the amount it pays to the financial advisers against the commission revenue it receives from the insurance company?

Answer

No. A is acting as a principal in providing services to the insurance company and not as an agent for the financial advisers. Accordingly, it is required to present the revenue it receives for those services as a gross amount.

10.5.8 Estimating Gross Revenue as a Principal

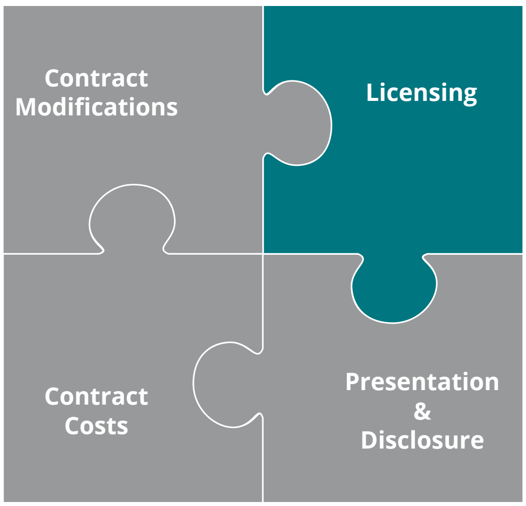
In deliberating ASU 2016-08 (*Clarifications to IFRS 15*), the FASB and IASB were informed of facts and circumstances under which an entity is determined to be a principal in a contract with a customer when there is uncertainty in the transaction price that is unlikely to be resolved. Such uncertainty may arise because the entity does not have, and will not obtain, sufficient transparency into the intermediary's pricing.

As noted in paragraph BC38 of ASU 2016-08, the FASB contemplated, but ultimately rejected, amendments to ASC 606 to address these types of transactions. Rather, the Board found the guidance in step 3 of the revenue model to be helpful in the determination of what amounts are variable consideration and thus should be included in the transaction price. Specifically, paragraph BC38(c) states:

> A key tenet of variable consideration is that at some point the uncertainty in the transaction price ultimately will be resolved. When the uncertainty is not expected to ultimately be resolved, the guidance indicates that the difference between the amount to which the entity is entitled from the intermediary and the amount charged by the intermediary to the end customer is not variable consideration and, therefore, is not part of the entity's transaction price.

Accordingly, for the transactions contemplated above, the Board found it reasonable for the principal to include in its transaction price the amounts known (i.e., the amounts to which the entity expects to be entitled from the intermediary).

Chapter 11 — Licensing



11.1 Overview

Under the new revenue standard, the framework used to account for licensing of intellectual property (IP) is essentially the same as the framework used to account for a sale of goods or services. That is, the five-step model is generally applied to licensing transactions as well. However, licensing of IP can take many forms, and the economics and substance of such transactions can often be difficult to identify. Determining how to account for licensing transactions will often depend on the specific facts and circumstances and will require the exercise of professional judgment. To help preparers exercise such judgment, the new revenue standard provides supplemental guidance on recognizing revenue from contracts related to the licensing of IP to customers. The scope of the guidance includes all licenses that provide a customer with rights to IP, except for certain software hosting arrangements.

In the evaluation of how to account for a licensing transaction under the new revenue standard, it is important for an entity to consider each of the five steps in the model (although, as discussed below, certain exceptions are provided for licensing transactions). Specifically, an entity will need to do each of the following:

- *Step 1: Identify the contract with the customer* — This step includes evaluating the enforceable rights and obligations (including implicit rights) of each party to the contract and determining whether amounts under the contract are collectible.
- *Step 2: Identify the performance obligation under the contract* — This includes determining whether the entity's obligation to transfer a license to a customer results in (1) a single promise that will be satisfied (i.e., a single performance obligation) or (2) multiple performance obligations. This step could also involve determining whether the license of IP is the predominant element in the arrangement.
- *Step 3: Determine the transaction price* — This includes identifying and, potentially, measuring and constraining variable consideration.
- *Step 4: Allocate the transaction price* — This includes considering whether the residual method could be used for determining the stand-alone selling price of one (or a bundle) of the performance obligations.
- *Step 5: Determining when control of the license is transferred to the customer* — This includes determining whether the license is transferred at a point in time (for a right to use IP) or over time (for a right to access IP).

Some of the key judgments an entity will need to make are likely to be in connection with step 2 (identify the performance obligations) and step 5 (recognize revenue) of the model. As part of step 2, an entity will need to evaluate license restrictions (and changes in any such restrictions) when determining whether the restrictions merely define the licenses (which may be the case when the restrictions are related to time or geography) or, in effect, give rise to multiple performance obligations (which may be the case when the restrictions change over the license period and require the entity to transfer additional rights to the customer).

As part of step 5, when an entity is determining whether it has granted a customer a right to use or a right to access its IP, it will need to (1) assess the nature of the promised license to determine whether the license has significant stand-alone functionality and (2) evaluate whether such functionality can be retained without ongoing activities of the entity. For licenses with significant stand-alone functionality, ongoing activities of the entity providing the license do not significantly affect the license's functionality (i.e., its utility). However, certain licenses do not have significant stand-alone functionality and require ongoing activities from the entity to support or maintain the license's utility to the customer. The nature of an entity's license of IP will determine the pattern of transfer of control to the customer, which is either at a point in time (if the customer is granted a right to use the IP) or over time (if the customer is granted a right to access the IP).

For licensing transactions in which consideration is tied to the subsequent sale or usage of IP, the new revenue standard provides an exception to the recognition principle that is part of step 5 (i.e., recognize revenue when or as control of the goods or services is transferred to the customer). Under this sales- or usage-based royalty exception, an entity would not estimate the variable consideration from sales- or usage-based royalties. Instead, the entity would wait until the subsequent sale or usage occurs to determine the amount of revenue to recognize.

As a result of implementation concerns raised by various stakeholders after the issuance of ASU 2014-09, the TRG discussed several licensing issues. After debating these issues, the TRG requested that the FASB issue clarifying guidance to help stakeholders apply the new revenue standard to licensing arrangements. In April 2016, the FASB issued ASU 2016-10, which was intended to improve the operability and understandability of the standard's licensing guidance on (1) determining the nature of the arrangement, (2) applying the sales- or usage-based royalty constraint, and (3) clarifying how contractual provisions affect licenses of IP.

11.2 Scope of the Licensing Guidance

ASC 606-10

55-54 A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology
b. Motion pictures, music, and other forms of media and entertainment
c. Franchises
d. Patents, trademarks, and copyrights.

Software in a hosting arrangement is excluded from the scope of the licensing guidance in the new revenue standard unless both of the following criteria in ASC 985-20-15-5 are met:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

Many software hosting arrangements include a "license" to software but allow the customer to use the software only in the entity's hosted environment (because of contractual or practical limitations, or both). Although these arrangements may include a contractual license, since the customer is unable to take possession of the software subject to the license without significant penalty, the customer is required to make a separate buying decision before control of any software is truly transferred to the customer (the separate buying decision would be the customer's election to incur the penalty to take possession of the software). These transactions are accounted for as service transactions (rather than licensing transactions) since the entity is providing the functionality of the software through a hosting arrangement rather than through the actual software license.

Thinking It Through — License Versus In-Substance Sale of IP

Other scope-related questions may require judgment. For example, stakeholders have raised implementation concerns regarding the evaluation of whether certain licensing arrangements that are in-substance sales of IP should be accounted for as sales of IP (subject to the new revenue standard's guidance on the sale of nonfinancial assets, which is discussed in Chapter 17) or as licenses of IP. For example, an entity may license IP to a customer under an arrangement that gives the customer exclusive use of the IP for a period that is substantially the same as the IP's useful life. Under current U.S. GAAP, revenue from an in-substance sale of IP is generally recognized at a point in time if the IP is determined to have stand-alone value.

Stakeholders have questioned whether these arrangements would be within the scope of (1) the licensing implementation guidance discussed in this chapter or (2) the general recognition and measurement model in the new revenue standard, which could result in a different pattern of revenue recognition. Specifically, concerns have been raised about the application of the sales- or usage-based royalty exception (see Section 11.6 below). The FASB considered, but rejected, expanding the scope of the royalty recognition constraint because of complexities in legal differences between a sale of IP and a license of IP. We generally believe that the legal form of the transaction will determine which revenue accounting guidance (i.e., the guidance on estimating royalties or the guidance on applying the royalty recognition constraint) is applicable. For an illustration of the scope of the sales- or usage-based royalty exception, see Q&A 11-7.

Q&A 11-1 Sales of Books, Recorded Music, and Similar Items

In many industries, it is common for an entity to sell a tangible product (e.g., a DVD, CD, or hard-copy book) that contains IP such as a movie, music, or a novel (a "copyrighted work").

The "first sale doctrine"[1] provides that an individual who purchases a copy of a copyrighted work from the copyright holder is the owner of that individual copy and receives the right to sell, lease, or otherwise dispose of that particular copy without the permission of the copyright owner. Therefore, the owner of an individual copy of IP controls the economic benefits of that copy of the copyrighted work. However, the owner of the copy has no right to the underlying copyright in the work and has only purchased use of that specific instance of the copyrighted work. While the term "first sale doctrine" is specific to U.S. law, many other jurisdictions have similar regulations related to copyrighted work.

Question

Is the licensing guidance in ASC 606-10-55-54 through 55-65B applicable to sales of goods subject to the first sale doctrine or other similar jurisdictional regulations?

Answer

No. An entity should not apply the implementation guidance on licenses in ASC 606-10-55-54 through 55-65B to sales of goods subject to the first sale doctrine or other similar jurisdictional regulations. Rather, such transactions should be considered sales of goods rather than licenses of IP.

Although there is a license to the IP incorporated in the good, the contract with the customer is an arrangement for the sale of a good (e.g., a single, physical copy of a book) rather than the IP. That is, sales of goods subject to the first sale doctrine should be evaluated as sales of tangible goods rather than licenses of IP. This is evidenced by the fact that the original purchaser of the goods relinquishes all rights to the underlying IP if they sell, or otherwise transfer, the associated goods to another party. As a result, the general guidance in ASC 606 should be applied to such sales in the same way it is applied to other sales of goods.

[1] The first sale doctrine, codified in 17 U.S.C. Section 109, provides that an individual who knowingly purchases a copy of a copyrighted work from the copyright holder receives the right to sell, display, or otherwise dispose of that particular copy notwithstanding the interests of the copyright owner. However, the right to distribute ends once the owner has sold that particular copy (see 17 U.S.C. Sections 109(a) and 109(c)). Since the first sale doctrine never protects a defendant who makes unauthorized reproductions of a copyrighted work, the first sale doctrine cannot be a successful defense in cases that allege infringing reproduction. Further, 17 U.S.C. Section 109(d) provides that the privileges created by the first sale principle do not "extend to any person who has acquired possession of the copy or phonorecord from the copyright owner, by rental, lease, loan, or otherwise, without acquiring ownership of it." Most computer software is distributed through the use of licensing agreements. Under this distribution system, the copyright holder remains the "owner" of all distributed copies. For this reason, alleged infringers should not be able to establish that any copies of these works have been the subject of a first sale. That is, sales of software will typically not be subject to the first sale doctrine.

In instances in which the entity also promises to provide the customer with the right to download a digital copy of the IP (e.g., a movie or song) that may be installed on a mobile device and this digital copy is subject to certain restrictive licensing terms and conditions that result in the inability to transfer the downloaded content to another party (i.e., the digital copy is not subject to the first sale doctrine), the entity should assess whether the promise to provide the download right is distinct. If the promise is distinct, the entity should apply the implementation guidance on licenses in ASC 606-10-55-58 through 55-65B.

11.3 Determining Whether a License Is Distinct

Licenses are often included with other goods or services in a contract. An entity will need to use judgment in determining whether a license (1) is distinct or (2) should be combined with other promised goods and services in the contract as a single performance obligation. An entity would apply the guidance in ASC 606-10-25-14 through 25-22 in identifying the performance obligations in the contract. The licensing implementation guidance is applicable to arrangements with customers that contain (1) a distinct license or (2) a license that is the predominant promised item in a performance obligation involving multiple goods or services.

ASC 606-10

55-55 In addition to a promise to grant a license (or licenses) to a customer, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the contract or implied by an entity's customary business practices, published policies, or specific statements (see paragraph 606-10-25-16). As with other types of contracts, when a contract with a customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity applies paragraphs 606-10-25-14 through 25-22 to identify each of the performance obligations in the contract.

55-56 If the promise to grant a license is not distinct from other promised goods or services in the contract in accordance with paragraphs 606-10-25-18 through 25-22, an entity should account for the promise to grant a license and those other promised goods or services together as a single performance obligation. Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

a. A license that forms a component of a tangible good and that is integral to the functionality of the good
b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

55-57 When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and, if over time, in selecting an appropriate method for measuring progress in accordance with paragraphs 606-10-25-31 through 25-37.

If an entity determines that a license is not distinct and should therefore be combined with other goods and services in a contract, the entity will need to evaluate the nature of the combined goods and services to determine (1) when the performance obligation is satisfied (i.e., at a point in time or over time) and (2) the appropriate method of measuring progress for revenue recognition over time, if applicable. This requirement is intended to ensure that the arrangement is accounted for in a manner that is consistent with the objective of the new revenue standard. That is, revenue is recognized when (or as) control of the good or service is transferred to the customer. For example, assume that a contract contains a five-year license for the right to access IP and a two-year service agreement, both of which meet the requirements for recognizing revenue over time. The license is not distinct and is therefore combined with the service agreement as a single performance obligation. In this example, it would not be appropriate to recognize revenue related to the five-year license over a two-year period.

The Codification examples below illustrate how an entity would apply the guidance on determining whether multiple goods and services promised in the entity's contract, including a license, are distinct.

ASC 606-10

Example 10 — Goods and Services Are Not Distinct

[Cases A and B omitted[2]]

Case C — Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

[2] Cases A and B of Example 10, on which Case C is based, are reproduced in Section 5.3.2.

ASC 606-10

Example 11 — Determining Whether Goods or Services Are Distinct

[Case A omitted[3]]

Case B — Significant Customization

55-146 [The facts of Case B are based on those of Case A (ASC 606-10-55-141 through 55-145). ASC 606-10-55-141 states that in Case A, an "entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support." In Case B, the] promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

55-147 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

55-148 On the basis of the same [analysis] as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

55-149 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization which is comprised of the license to the software and the customized installation service
b. Software updates
c. Technical support.

55-150 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

[3] Case A of Example 11, on which Case B is based, is reproduced in Section 5.3.2.3.

ASC 606-10

Example 56 — Identifying a Distinct License

55-367 An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer for 5 years, while the customer develops its own manufacturing capability. The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical composition). There are no other promised goods or services in the contract.

Case A — License Is Not Distinct

55-368 In this case, no other entity can manufacture this drug while the customer learns the manufacturing process and builds its own manufacturing capability because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing service.

55-369 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer cannot benefit from the license without the manufacturing service; therefore, the criterion in paragraph 606-10-25-19(a) is not met. Consequently, the license and the manufacturing service are not distinct, and the entity accounts for the license and the manufacturing service as a single performance obligation.

55-370 The nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years; the customer benefits from the license only as a result of having access to a supply of the drug. After the first five years, the customer retains solely the right to use the entity's functional intellectual property (see Case B, paragraph 606-10-55-373), and no further performance is required of the entity during Years 6–10. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation (that is, the bundle of the license and the manufacturing service) is a performance obligation satisfied at a point in time or over time. Regardless of the determination reached in accordance with paragraphs 606-10-25-23 through 25-30, the entity's performance under the contract will be complete at the end of Year 5.

Case B — License Is Distinct

55-371 In this case, the manufacturing process used to produce the drug is not unique or specialized, and several other entities also can manufacture the drug for the customer.

55-372 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 606-10-25-19 are met for each of the license and the manufacturing service. The entity concludes that the criterion in paragraph 606-10-25-19(a) is met because the customer can benefit from the license together with readily available resources other than the entity's manufacturing service (that is, because there are other entities that can provide the manufacturing service) and can benefit from the manufacturing service together with the license transferred to the customer at the start of the contract.

ASC 606-10 (continued)

55-372A The entity also concludes that its promises to grant the license and to provide the manufacturing service are separately identifiable (that is, the criterion in paragraph 606-10-25-19(b) is met). The entity concludes that the license and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 606-10-25-21. In reaching this conclusion, the entity considers that the customer could separately purchase the license without significantly affecting its ability to benefit from the license. Neither the license nor the manufacturing service is significantly modified or customized by the other, and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the license and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the license independent of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the license and initially utilized a different manufacturer. Thus, although the manufacturing service necessarily depends on the license in this contract (that is, the entity would not contract for the manufacturing service without the customer having obtained the license), the license and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the license and to provide the manufacturing service are distinct and that there are two performance obligations:

a. License of patent rights
b. Manufacturing service.

55-373 The entity assesses the nature of its promise to grant the license. The entity concludes that the patented drug formula is functional intellectual property (that is, it has significant standalone functionality in the form of its ability to treat a disease or condition). There is no expectation that the entity will undertake activities to change the functionality of the drug formula during the license period. Because the intellectual property has significant standalone functionality, any other activities the entity might undertake (for example, promotional activities like advertising or activities to develop other drug products) would not significantly affect the utility of the licensed intellectual property. Consequently, the nature of the entity's promise in transferring the license is to provide a right to use the entity's functional intellectual property, and it accounts for the license as a performance obligation satisfied at a point in time. The entity recognizes revenue for the license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

55-374 In its assessment of the nature of the license, the entity does not consider the manufacturing service because it is an additional promised service in the contract. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time.

11.4 Determining Whether Contractual Provisions Represent Attributes of a License or Additional Rights

A contract with a customer may contain provisions that limit the customer's use of a license of IP to a specific period, a specific geographical region, or a specific use. For example, an entity may license media content to a customer that can be (1) used for three years, (2) made available only to consumers in North America, and (3) broadcasted only on a specific network. Often, such restrictions will be attributes of the license. That is, the restrictions will define the rights the customer has under the license, and all of those rights will be transferred to the customer either at a point in time (if the license is a right to use IP) or over time (if the license is a right to access IP). However, some restrictions, or changes in restrictions over time, will require an entity to transfer additional rights to a customer. Specifically, the amendments in ASU 2016-10 clarify that (1) certain contractual provisions indicate that an entity has promised to transfer additional rights (i.e., an additional license) to a customer and (2) promises to transfer additional rights should be accounted for as separate performance obligations.

ASC 606-10

55-64 Contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer (for example, by requiring the entity to transfer control of additional rights to use or rights to access intellectual property that the customer does not already control) should be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property. . . .

55-64A Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use [do] not affect whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

The determination of whether contractual provisions related to a license of IP represent an additional promise may require significant judgment. Contractual provisions (restrictions) that define the scope of a license of IP that has already been transferred to a customer would generally not be accounted for as a separate performance obligation. For example, a restriction that limits the use of a license to a five-year period would be an attribute of the single license. However, contractual provisions that define additional rights that will be transferred at a future date would generally be accounted for as a separate performance obligation, as illustrated in the following example:

Example 11-1

An entity transfers to a customer a two-year license of IP that can be used only in Jurisdiction A during year 1 but can be used in both Jurisdiction A and Jurisdiction B during year 2. In this example, the customer does not obtain control of the license in Jurisdiction B until year 2. That is, in year 2, the entity must transfer additional rights that entitle the customer to use the license in Jurisdiction B. Although the entity transfers the license to use the IP in Jurisdiction A at the beginning of year 1, the entity must still fulfill a second promise to deliver the license to use the IP in Jurisdiction B in year 2. Although the license of IP obtained by the customer in year 1 may be the same license of IP that will be used in year 2 (i.e., the customer currently controls the right to use or access the IP), the customer is precluded from using and benefiting from that license in Jurisdiction B until year 2. The obligation to transfer additional rights to the customer at the beginning of year 2 should be identified as an additional performance obligation under the contract with the customer.

The Codification examples below illustrate how an entity would apply the guidance on determining whether contractual provisions represent attributes of a license or additional promises to a customer.

ASC 606-10

Example 59 — Right to Use Intellectual Property

Case A — Initial License

55-389 An entity, a music record label, licenses to a customer a recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for two years in Country A starting on January 1, 20X1. In exchange for providing the license, the entity receives fixed consideration of $10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is noncancellable.

ASC 606-10 (continued)

55-390 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that its only performance obligation is to grant the license. The term of the license (two years), the geographical scope of the license (that is, the customer's right to use the symphony only in Country A), and the defined permitted uses for the recording (that is, use in commercials) are all attributes of the promised license in this contract.

55-391 In determining that the promised license provides the customer with a right to use its intellectual property as it exists at the point in time at which the license is granted, the entity considers the following:

a. The classical symphony recording has significant standalone functionality because the recording can be played in its present, completed form without the entity's further involvement. The customer can derive substantial benefit from that functionality regardless of the entity's further activities or actions. Therefore, the nature of the licensed intellectual property is functional.
b. The contract does not require, and the customer does not reasonably expect, that the entity will undertake activities to change the licensed recording.

Therefore, the criteria in paragraph 606-10-55-62 are not met.

55-392 In accordance with paragraph 606-10-55-58B, the promised license, which provides the customer with a right to use the entity's intellectual property, is a performance obligation satisfied at a point in time. The entity recognizes revenue from the satisfaction of that performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Additionally, because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

ASC 606-10

Example 61B — Distinguishing Multiple Licenses From Attributes of a Single License

55-399K On December 15, 20X0, an entity enters into a contract with a customer that permits the customer to embed the entity's functional intellectual property in two classes of the customer's consumer products (Class 1 and Class 2) for five years beginning on January 1, 20X1. During the first year of the license period, the customer is permitted to embed the entity's intellectual property only in Class 1. Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is permitted to embed the entity's intellectual property in Class 2. There is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period. There are no other promised goods or services in the contract. The entity provides (or otherwise makes available — for example, makes available for download) a copy of the intellectual property to the customer on December 20, 20X0.

55-399L In identifying the goods and services promised to the customer in the contract (in accordance with guidance in paragraphs 606-10-25-14 through 25-18), the entity considers whether the contract grants the customer a single promise, for which an attribute of the promised license is that during Year 1 of the contract the customer is restricted from embedding the intellectual property in the Class 2 consumer products), or two promises (that is, a license for a right to embed the entity's intellectual property in Class 1 for a five-year period beginning on January 1, 20X1, and a right to embed the entity's intellectual property in Class 2 for a four-year period beginning on January 1, 20X2).

55-399M In making this assessment, the entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's intellectual property in Class 2 only commences one year after the right for the customer to embed the entity's intellectual property in Class 1 means that after the customer can begin to use and benefit from its right to embed the entity's intellectual property in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed intellectual property (that is, the entity must still fulfill its promise to grant the customer the right to embed the entity's intellectual property in Class 2). The entity does not transfer control of the right to embed the entity's intellectual property in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

ASC 606-10 (continued)

55-399N The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the other. Therefore, each right is capable of being distinct in accordance with paragraph 606-10-25-19(a)). In addition, the entity concludes that the promise to transfer each license is separately identifiable (that is, each right meets the criterion in paragraph 606-10-25-19(b)) on the basis of an evaluation of the principle and the factors in paragraph 606-10-25-21. The entity concludes that it is not providing any integration service with respect to the two rights (that is, the two rights are not inputs to a combined output with functionality that is different from the functionality provided by the licenses independently), neither right significantly modifies or customizes the other, and the entity can fulfill its promise to transfer each right to the customer independently of the other (that is, the entity could transfer either right to the customer without transferring the other). In addition, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

55-399O Because each right is distinct, they constitute separate performance obligations. On the basis of the nature of the licensed intellectual property and the fact that there is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period, each promise to transfer one of the two licenses in this contract provides the customer with a right to use the entity's intellectual property and the entity's promise to transfer each license is, therefore, satisfied at a point in time. The entity determines at what point in time to recognize the revenue allocable to each performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Because a customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

Driving Discussion — Additional Users Versus Additional Usage

A license arrangement accounted for as a right-to-use license (i.e., a license for which revenue is recognized at a point in time) may (1) transfer a license and require the customer to make a fixed payment at inception and (2) include an option for the customer to obtain additional rights that allow the software to be used by additional users for incremental fees per user. Alternatively (or in addition), a right-to-use license arrangement may provide for "additional usage" of a single license in exchange for incremental fees per use.

An entity in a right-to-use license arrangement will need to use judgment to determine whether the nature of the arrangement is one that provides an option to obtain additional rights (e.g., for additional users) or requires incremental fees to be paid for additional usage of rights already controlled by the customer.

Additional Users

An arrangement in which an entity provides an option to the customer to obtain rights for additional users effectively promises to provide additional licenses (i.e., additional performance obligations) for an incremental fee. Those optional additional purchases (i.e., options that would require an entity to transfer additional rights to the customer) would not initially be included in the contract; however, they should be evaluated for favorable terms that may give rise to a material right. See Q&A 11-2.

Additional Usage

Alternatively, an arrangement in which an entity provides additional usage of a single license (i.e., usage of rights already controlled by the customer) would receive additional consideration as part of the transaction price for a single license. Because the additional potential consideration is based on usage of a single license, it would be subject to the sales- or usage-based royalty exception and be recognized when the subsequent usage occurs.

Q&A 11-2 Accounting for a Customer's Option to Purchase or Use Additional Copies of Software — Material Right Assessment

Question

If an entity in a right-to-use license arrangement determines that the arrangement provides for additional users, does the entity need to perform an evaluation in accordance with ASC 606-10-55-42 to determine whether the customer's option to add software users at a later date on the basis of a per-user fee represents a material right?

Answer

Yes. If the contract includes an option to acquire additional software rights, it would be evaluated as an option to acquire additional goods or services. Accordingly, the entity must determine whether the option represents a material right in accordance with ASC 606-10-55-42 and, if so, allocate a portion of the transaction price for the initial software rights to the material right.

If the option does not represent a material right, the entity would not account for the additional software rights until the subsequent purchases for additional software users occur. This accounting outcome (i.e., no identification of a material right) results in a recognition pattern similar to that of an arrangement that is determined to allow for additional usage. When the arrangement is determined to provide for additional usage, consideration for that incremental usage is deemed to be variable consideration for the license already transferred. Therefore, since the arrangement includes a license of IP, the sales- or usage-based royalty guidance in ASC 606-10-55-65 would apply. As a result, revenue would be recognized when the subsequent usage occurs.

The TRG discussed this issue in November 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 49. For additional information and Deloitte's summary, see Appendixes D and E.

Q&A 11-3 Accounting for a Customer's Option to Purchase or Use Additional Copies of Software — Customer's Ability to Access or Download Additional Copies of the Software

Adding users at a later date may or may not require additional direct involvement by the vendor (i.e., to provide access to additional copies of the software).

Example

A customer in a software arrangement pays a fixed fee of $300,000 for up to 500 copies of the software. Each copy can only have a single user. The customer pays an additional $400 per copy for copies in excess of the initial 500. The number of copies is measured, and the customer pays for any additional users each quarter.

Consider the following scenarios:

- *Scenario A* — The customer has been given a master copy of the software and has the technical capability and legal right to create an unlimited number of copies without any further assistance from the vendor.
- *Scenario B* — The customer has been given access to download copies of the software and has the technical capability and legal right to download an unlimited number of copies without any further direct involvement by the vendor.
- *Scenario C* — The customer must request, and the vendor must provide, access codes for any additional downloads.

Question

Does the accounting for the arrangement (as either additional usage or additional users) vary depending on whether adding users requires additional direct involvement by the vendor (i.e., as in Scenario C, but not in Scenarios A and B)?

Answer

No. An entity must use judgment to determine whether a particular fact pattern should be regarded as additional usage (one license) or additional users (multiple licenses). However, this judgment is not solely affected by whether adding users requires additional direct involvement by the vendor.

In Scenario C, the fact that the customer cannot obtain additional copies of the software without the vendor's direct involvement does not in itself prevent the nature of the arrangement from being additional usage (one license). As discussed in Q&A 11-5, control of software may be determined to have passed to a customer before the software is downloaded if the seller has nevertheless made the software available.

In Scenarios A and B, if the nature of the arrangement is determined to be additional users (multiple licenses), the fact that the customer can obtain additional copies of the software without the vendor's direct involvement does not in itself mean that the customer controls the additional licenses and that the vendor has satisfied its performance obligation. The vendor's performance obligation includes not only making the IP available to the customer but also the act of granting those rights.

Accordingly, the outcome of the accounting analysis does not depend on whether adding users requires additional direct involvement by the vendor. In all three scenarios above, the arrangement should be evaluated to determine whether the contract provides for **additional users** (i.e., separate performance obligations that should be evaluated in accordance with the guidance in ASC 606-10-55-42 on options to acquire additional goods or services) or **additional usage** of a single license that was already delivered.

The TRG discussed this issue in November 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 49. For additional information and Deloitte's summary, see Appendixes D and E.

11.5 Identifying the Nature of the License

Current guidance under U.S. GAAP does not provide a single, comprehensive framework for recognizing revenue from licenses of IP. In determining how to recognize license revenue under existing U.S. GAAP, various entities have relied on industry- and transaction-specific guidance, which emerged over time because of the wide variety of licenses. For example, software entities have referred to ASC 985-605 (formerly SOP 97-2), franchisors have looked to ASC 952-605 (formerly FAS 45), and entities in the film industry have turned to ASC 926-605 (formerly SOP 00-2). Other entities have applied the general revenue recognition guidance in ASC 605-10-S99 (SAB Topic 13). In developing the new revenue standard, the FASB and IASB committed to developing a single framework to apply to all types of revenue-generating transactions, including licenses of IP. Because the boards decided to shift from industry- and transaction-specific guidance to a single framework, application of the new revenue standard could produce outcomes significantly different from those resulting from application of the current guidance.

As discussed in paragraph BC403 of ASU 2014-09, applying a single framework to licenses of IP proved to be challenging because "licenses vary significantly and include a wide array of different features and economic characteristics, which lead to significant differences in the rights provided by a license." The boards acknowledged that in some situations, a customer may be unable to control the license at the time of transfer because of the nature of the underlying IP and the entity's potential continuing involvement in the IP. However, this is not always the case. Therefore, the boards recognized that in a manner consistent with the general revenue recognition model under the new standard, control of some licenses may be transferred at a point in time while control of other licenses may be transferred over time.

ASC 606-10

55-58 In evaluating whether a license transfers to a customer at a point in time or over time, an entity should consider whether the nature of the entity's promise in granting the license to a customer is to provide the customer with either:

a. A right to access the entity's intellectual property throughout the license period (or its remaining economic life, if shorter)
b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

ASC 606-10 (continued)

55-58A An entity should account for a promise to provide a customer with a right to access the entity's intellectual property as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 606-10-25-27(a)). An entity should apply paragraphs 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

55-58B An entity's promise to provide a customer with the right to use its intellectual property is satisfied at a point in time. The entity should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer.

In determining whether to recognize revenue from a license of IP over time or at a point in time, an entity needs to determine the nature of the licensing arrangement. The nature of the arrangement is determined on the basis of the entity's promise to the customer and whether that promise (1) provides access to the IP throughout the license term (i.e., "right to access") or (2) provides a right to use the IP as it exists at the point in time when control of the license is transferred to the customer (i.e., "right to use"). Revenue from a license that grants a right to access an entity's IP is recognized over time since the customer simultaneously receives and consumes the benefits of the entity's IP throughout the license periods (i.e., meets the requirement in ASC 606-10-25-27(a)). Revenue from a license that grants a right to use an entity's IP is recognized at the point in time when control of the license is transferred to the customer. An entity's determination of when control of a license has been transferred to a customer should be based, in part, on the indicators in ASC 606-10-25-30. However, control of a license cannot be transferred to a customer before the customer is able to use and benefit from the license (i.e., the license term has commenced). For further discussion, see Section 11.5.3.

To help an entity determine whether a license is a right to access or right to use the entity's IP, the new revenue standard provides guidance on assessing the nature of a license of IP. An entity's ongoing activities, or lack of activities, may significantly affect the utility of the license (i.e., the functionality or value of the IP to the customer). These activities may be explicitly or implicitly promised by the entity and may include supporting or maintaining its IP for the duration of the customer's license period. Further, the obligation to maintain or support the IP may need to be identified as a separate promise under the contract (insofar as the activities transfer additional goods or services to the customer). To assist in the evaluation of whether the license provides the customer with a right to access or right to use the entity's IP, the new revenue standard distinguishes between two types of IP: (1) functional and (2) symbolic.

ASC 606-10

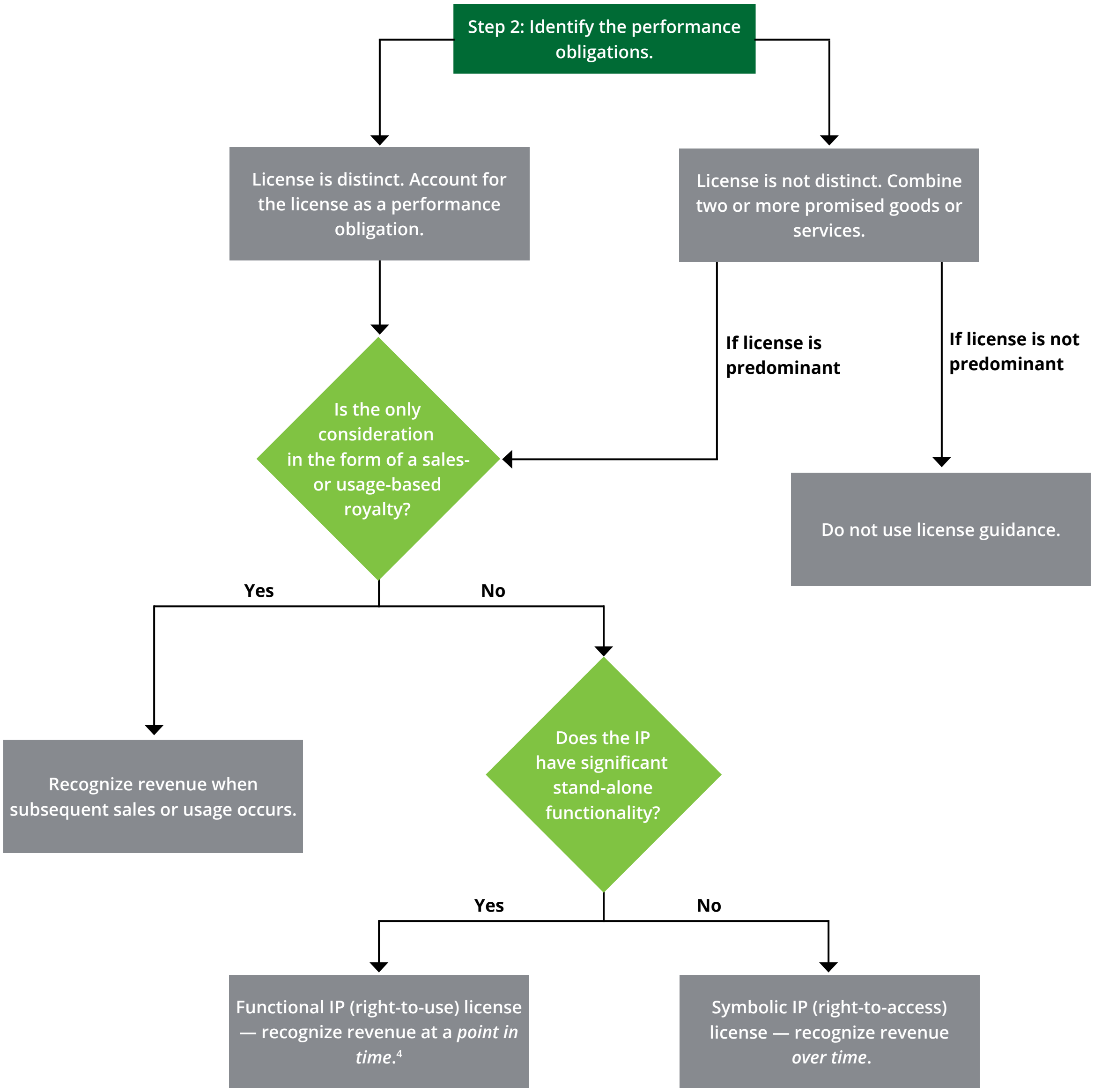
55-59 To determine whether the entity's promise [is] to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

a. Functional intellectual property. Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.

b. Symbolic intellectual property. Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

In the original guidance issued in ASU 2014-09, the FASB and IASB decided that the determination of whether a license grants the customer a right to access or right to use the entity's IP should hinge on whether the licensor's ongoing activities are expected to significantly affect the underlying IP. Stakeholders identified significant implementation questions, which focused mainly on (1) the nature of the licensor's activities that affect the IP and (2) how entities should evaluate the impact of such activities on the IP (e.g., the effect on the IP's form and functionality, value, or both). Those questions were discussed by the TRG, and the TRG acknowledged that different interpretations may arise between what constitutes a right-to-access and a right-to-use license. As a result, the FASB decided to clarify the guidance on identifying the nature of a license. As indicated in ASC 606-10-55-59 (as amended by ASU 2016-10), the Board decided that the assessment of whether a license provides the customer with a right to access or a right to use the entity's IP should be based on whether the underlying IP is functional or symbolic. Refer to Sections 11.5.1 and 11.5.2 for additional information on functional and symbolic IP.

The following flowchart illustrates the process for determining the nature of an entity's license of IP to a customer (i.e., whether the license is a right to use or a right to access the entity's IP), as well as other considerations related to licenses of IP:



11.5.1 Functional IP

IP may have significant stand-alone functionality. For example, some IP can be aired or viewed (e.g., a song or a movie) or can perform a task. The functionality (i.e., ongoing utility) of this IP is not affected by the entity's activities (or lack of activities) that do not transfer an additional good or service to the customer. That is, the customer controls the functionality provided by the license to IP when control of the IP is transferred to the customer. Any activities the entity undertakes to maintain or enhance the IP are likely to be identified as a separate promise under the contract. A license in these circumstances can be referred to as a license of functional IP. Examples of licenses of functional IP could include software, drug compounds and formulas, and completed media content (such as films, television shows, or music).

[4] For further discussion of a limited exception, see Section 11.5.1.

ASC 606-10

55-63 Because functional intellectual property has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the intellectual property to which the customer has rights. Therefore, the entity's promise to the customer in granting a license to functional intellectual property does not include supporting or maintaining the intellectual property. Consequently, if a license to functional intellectual property is a separate performance obligation (see paragraph 606-10-55-55) and does not meet the criteria in paragraph 606-10-55-62, it is satisfied at a point in time (see paragraphs 606-10-55-58B through 55-58C).

ASC 606-10

55-62 A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.
b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

Generally, the nature of a license to functional IP that is distinct will provide a customer with the right to use an entity's IP (i.e., point-in-time revenue recognition) unless (1) the entity's ongoing activities that will not transfer promised goods to the customer (i.e., those not deemed to be additional promised goods to the customer) will significantly change the utility of the license and (2) the customer is contractually or practically required to use the updated IP once available. If these criteria are met, the nature of the license is a right to access the entity's IP (i.e., a license for which revenue is recognized over time). As discussed in paragraph BC58 of ASU 2016-10, the FASB expected that at the time of issuance of ASU 2016-10, the criteria in ASC 606-10-55-62 "will be met only infrequently, if at all."

ASC 606-10

Example 54 — Right to Use Intellectual Property

55-362 Using the same facts as in Case A in Example 11 (see paragraphs 606-10-55-141 through 55-145), the entity identifies four performance obligations in a contract:

a. The software license
b. Installation services
c. Software updates
d. Technical support.

55-363 The entity assesses the nature of its promise to transfer the software license. The entity first concludes that the software to which the customer obtains rights as a result of the license is functional intellectual property. This is because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

ASC 606-10 (continued)

55-363A The entity further concludes that while the functionality of the underlying software is expected to change during the license period as a result of the entity's continued development efforts, the functionality of the software to which the customer has rights (that is, the customer's instance of the software) will change only as a result of the entity's promise to provide when-and-if available software updates. Because the entity's promise to provide software updates represents an additional promised service in the contract, the entity's activities to fulfill that promised service are not considered in evaluating the criteria in paragraph 606-10-55-62. The entity further notes that the customer has the right to install, or not install, software updates when they are provided such that the criterion in 606-10-55-62(b) would not be met even if the entity's activities to develop and provide software updates had met the criterion in paragraph 606-10-55-62(a).

55-363B Therefore, the entity concludes that it has provided the customer with a right to use its software as it exists at the point in time the license is granted and the entity accounts for the software license performance obligation as a performance obligation satisfied at a point in time. The entity recognizes revenue on the software license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

ASC 606-10

Example 61A — Right to Use Intellectual Property

55-399A An entity, a television production company, licenses all of the existing episodes of a television show (which consists of the first four seasons) to a customer. The show is presently in its fifth season, and the television production company is producing episodes for that fifth season at the time the contract is entered into, as well as promoting the show to attract further viewership. The Season 5 episodes in production are still subject to change before airing.

Case A — License Is the Only Promise in the Contract

55-399B The customer obtains the right to broadcast the existing episodes, in sequential order, for a period of two years. The show has been successful through the first four seasons, and the customer is both aware that Season 5 already is in production and aware of the entity's continued promotion of the show. The customer will make fixed monthly payments of an equal amount throughout the two-year license period.

55-399C The entity assesses the goods and services promised to the customer. The entity's activities to produce Season 5 and its continued promotion of the show do not transfer a promised good or service to the customer. Therefore, the entity concludes that there are no other promised goods or services in the contract other than the license to broadcast the existing episodes in the television series. The contractual requirement to broadcast the episodes in sequential order is an attribute of the license (that is, a restriction on how the customer may use the license); therefore, the only performance obligation in this contract is the single license to the completed Seasons 1–4.

55-399D To determine whether the promised license provides the customer with a right to use its intellectual property or a right to access its intellectual property, the entity evaluates the intellectual property that is the subject of the license. The existing episodes have substantial standalone functionality at the point in time they are transferred to the customer because the episodes can be aired, in the form transferred, without any further participation by the entity. Therefore, the customer can derive substantial benefit from the completed episodes, which have significant utility to the customer without any further activities of the entity. The entity further observes that the existing episodes are complete and not subject to change. Thus, there is no expectation that the functionality of the intellectual property to which the customer has rights will change (that is, the criteria in paragraph 606-10-55-62 are not met). Therefore, the entity concludes that the license provides the customer with a right to use its functional intellectual property.

ASC 606-10 (continued)

55-399E Consequently, in accordance with paragraph 606-10-55-58B, the license is a performance obligation satisfied at a point in time. In accordance with paragraphs 606-10-55-58B through 55-58C, the entity recognizes revenue for the license on the date that the customer is first permitted to air the licensed content, assuming the content is made available to the customer on or before that date. The date the customer is first permitted to air the licensed content is the beginning of the period during which the customer is able to use and benefit from its right to use the intellectual property. Because of the length of time between the entity's performance (at the beginning of the period) and the customer's annual payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

Case B — Contract Includes Two Promises

55-399F Consistent with Case A, the contract provides the customer with the right to broadcast the existing episodes, in sequential order, over a period of two years. The contract also grants the customer the right to broadcast the episodes being produced for Season 5 once all of those episodes are completed.

55-399G The entity assesses the goods and services promised to the customer. The entity concludes that there are two promised goods or services in the contract:

a. The license to the existing episodes (see paragraph 606-10-55-399C)
b. The license to the episodes comprising Season 5, when all of those episodes are completed.

55-399H The entity then evaluates whether the license to the existing content is distinct from the license to the Season 5 episodes when they are completed. The entity concludes that the two licenses are distinct from each other and, therefore, separate performance obligations. This conclusion is based on the following analysis:

a. Each license is capable of being distinct because the customer can benefit from its right to air the existing completed episodes on their own and can benefit from the right to air the episodes comprising Season 5, when they are all completed, on their own and together with the right to air the existing completed content.
b. Each of the two promises to transfer a license in the contract also is separately identifiable; they do not, together, constitute a single overall promise to the customer. The existing episodes do not modify or customize the Season 5 episodes in production, and the existing episodes do not, together with the pending Season 5 episodes, result in a combined functionality or changed content. The right to air the existing content and the right to air the Season 5 content, when available, are not highly interdependent or highly interrelated because the entity's ability to fulfill its promise to transfer either license is unaffected by its promise to transfer the other. In addition, whether the customer or another licensee had rights to air the future episodes would not be expected to significantly affect the customer's license to air the existing, completed episodes (for example, viewers' desire to watch existing episodes from Seasons 1–4 on the customer's network generally would not be significantly affected by whether the customer, or another network, had the right to broadcast the episodes that will comprise Season 5).

ASC 606-10 (continued)

55-399I The entity assesses the nature of the two separate performance obligations (that is, the license to the existing, completed episodes of the series and the license to episodes that will comprise Season 5 when completed). To determine whether the licenses provide the customer with rights to use the entity's intellectual property or rights to access the entity's intellectual property, the entity considers the following:

a. The licensed intellectual property (that is, the completed episodes in Seasons 1–4 and the episodes in Season 5, when completed) has significant standalone functionality separate from the entity's ongoing business activities, such as in producing additional intellectual property (for example, future seasons) or in promoting the show, and completed episodes can be aired without the entity's further involvement.

b. There is no expectation that the entity will substantively change any of the content once it is made available to the customer for broadcast (that is, the criteria in paragraph 606-10-55-62 are not met).

c. The activities expected to be undertaken by the entity to produce Season 5 and transfer the right to air those episodes constitute an additional promised good (license) in the contract and, therefore, do not affect the nature of the entity's promise in granting the license to Seasons 1–4.

55-399J Therefore, the entity concludes that both the license to the existing episodes in the series and the license to the episodes that will comprise Season 5 provide the customer with the right to use its functional intellectual property as it exists at the point in time the license is granted. As a result, the entity recognizes the portion of the transaction price allocated to each license at a point in time in accordance with paragraphs 606-10-55-58B through 55-58C. That is, the entity recognizes the revenue attributable to each license on the date that the customer is first permitted to first air the content included in each performance obligation. That date is the beginning of the period during which the customer is able to use and benefit from its right to use the licensed intellectual property.

11.5.2 Symbolic IP

Some forms of IP may not have stand-alone functionality when transferred to a customer. The utility of these forms of IP is significantly derived from the entity's past or ongoing activities undertaken to maintain or support the IP, and such activities do not transfer additional goods or services to the customer. That is, the value of the IP is largely dependent on the entity's ongoing support or maintenance of that IP. In addition, the customer is contractually or practically required to use the updated IP, which is consistent with a license to functional IP that provides the customer with a right to access the entity's IP. Licenses to IP whose value is derived from an entity's ongoing activities may include brands, teams, trade names, logos, and franchise rights. For example, a license to a sports team's name is directly affected by the team's performance and its continued association with the league in which it plays. If the team ceases to play games, the value of the IP would most likely decline significantly. Further, a customer could not choose to use the form of the IP that existed when the team was still playing games. Rather, the customer has to use the most current form of the IP. These types of IP are referred to as symbolic IP.

ASC 606-10

55-60 A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs 606-10-55-58A and 606-10-55-58C) as the entity fulfills its promise to both:

a. Grant the customer rights to use and benefit from the entity's intellectual property

b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

A symbolic license contains the characteristics of a right-to-access license (i.e., a license for which revenue is recognized over time) since the customer is simultaneously receiving the IP and benefiting from it throughout the license period. An entity's ongoing activities (including actions that would significantly degrade the IP's utility) will continue to support or maintain (or significantly degrade) the IP's utility.

ASC 606-10

Example 55 — License of Intellectual Property

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

ASC 606-10

Example 58 — Access to Intellectual Property

55-383 An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. There are main characters involved in each of the comic strips. However, newly created characters appear and disappear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in shows or parades, within reasonable guidelines.

55-384 In exchange for granting the license, the entity receives a fixed payment of $1 million in each year of the 4-year term.

55-385 The entity concludes that it has made no other promises to the customer other than the promise to grant a license. That is, the additional activities associated with the license do not directly transfer a good or service to the customer. Therefore, the entity concludes that its only performance obligation is to transfer the license.

55-386 The entity assesses the nature of its promise to transfer the license and concludes that the nature of its promise is to grant the customer the right to access the entity's symbolic intellectual property. The entity determines that the licensed intellectual property (that is, the character names and images) is symbolic because it has no standalone functionality (the names and images cannot process a transaction, perform a function or task, or be played or aired separate from significant additional production that would, for example, use the images to create a movie or a show) and the utility of those names and images is derived from the entity's past and ongoing activities such as producing the weekly comic strip that includes the characters. . . .

55-387 Because the nature of the entity's promise in granting the license is to provide the customer with a right to access the entity's intellectual property, in accordance with paragraph 606-10-55-58A, the entity accounts for the promised license as a performance obligation satisfied over time.

55-388 The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. The entity considers paragraphs 606-10-25-31 through 25-37 in identifying the method that best depicts its performance in the license. Because the contract provides the customer with unlimited use of the licensed characters for a fixed term, the entity determines that a time-based method would be the most appropriate measure of progress toward complete satisfaction of the performance obligation.

ASC 606-10

Example 61 — Access to Intellectual Property

55-395 An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs, and towels for one year. In exchange for providing the license, the entity will receive fixed consideration of $2 million and a royalty of 5 percent of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

55-396 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that the only good or service promised to the customer in the contract is the license. The additional activities associated with the license (that is, continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer. Therefore, there is one performance obligation in the contract.

55-397 To determine whether the entity's promise in granting the license provides the customer with a right to access the entity's intellectual property or a right to use the entity's intellectual property, the entity assesses the nature of the intellectual property to which the customer obtains rights. The entity concludes that the intellectual property to which the customer obtains rights is symbolic intellectual property. The utility of the team name and logo to the customer is derived from the entity's past and ongoing activities of playing games and providing a competitive team (that is, those activities effectively give value to the intellectual property). Absent those activities, the team name and logo would have little or no utility to the customer because they have no standalone functionality (that is, no ability to perform or fulfill a task separate from their role as symbols of the entity's past and ongoing activities). . . .

ASC 606-10 (continued)

55-398 Consequently, the entity's promise in granting the license provides the customer with the right to access the entity's intellectual property throughout the license period and, in accordance with paragraph 606-10-55-58A, the entity accounts for the promised license as a performance obligation satisfied over time.

55-399 The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license. For the consideration that is in the form of a sales-based royalty, paragraph 606-10-55-65 applies because the sales-based royalty relates solely to the license that is the only performance obligation in the contract. The entity concludes that recognizing revenue from the sales-based royalty when the customer's subsequent sales of items using the team name or logo occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed consideration of $2 million plus recognition of the royalty fees as the customer's subsequent sales occur reasonably depict the entity's progress toward complete satisfaction of the license performance obligation.

Thinking It Through — Case-by-Case Assessment

In some instances, identifying the nature of a license is straightforward and the outcome of whether the license provides the customer with a right to access or a right to use the entity's IP is readily apparent. However, in other situations, this assessment is more complicated and requires significant consideration and judgment. Specifically, this may be the case when the entity promises to provide multiple nonlicense goods and services in addition to the license, or when the license is subject to various restrictions. As discussed above, there are many factors that influence the recognition of revenue from a license of IP. Therefore, it is important to evaluate all of the steps within the flowchart in Section 11.5, and to not assume that certain types of licenses should always be accounted for in a similar manner.

11.5.3 Transfer of Control

ASC 606-10

55-58C Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.
b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

Determining when control has been transferred to a customer may be difficult in certain arrangements related to the licensing of IP, specifically those related to software that is delivered electronically. Consider the Q&As below.

Q&A 11-4 Electronic Delivery of Software — Assessing When Control Is Transferred to the Customer for a Suite of Software Licenses

Entity X enters into a five-year license agreement with Customer B under which B purchases licenses to a suite of software products consisting of five modules. At the inception of the arrangement, B is required to make a nonrefundable payment of $5 million to X for the licenses to all five modules, and the license term for the suite of licenses begins on January 1, 20X5. Customer B has previewed all five modules and accepted the software as of January 1, 20X5, but has only obtained the access codes for, and downloaded, four of the five modules. Customer B installs the modules itself and expects that it will take three months to install the four modules. Customer B does not download the fifth module immediately because of system limitations but plans to obtain the access code and install the fifth module once installation of the first four modules is complete. The access code for the fifth module is available to B on demand.

Question

When is control of the suite of software licenses transferred to B?

Answer

In this scenario:

- Customer B is required to pay the nonrefundable license fee at the inception of the arrangement and has accepted the software.
- The license terms have begun.
- The access code for the fifth module is available to B at any time on demand.

Assuming that no other indicators of control are present, it seems reasonable for X to conclude that control of the licenses for all five modules is transferred to B on January 1, 20X5.

Q&A 11-5 Electronic Delivery of Software — Assessing When Control Is Transferred to the Customer When the License Requires an Access Code or Product Key

In certain software licensing arrangements, an access code or product key is required for the customer to access the software. For example, Entity X sells software licenses to customers that represent right-to-use licenses (for which revenue is recognized at a point in time) and give customers access to the software via X's Web site. Customers need either an access code to download the software or a product key to activate the software once downloaded. The software cannot be used on the customer's hardware without the access code or the product key.

Question

Must X deliver the access code or product key to the customer to conclude that control of the software license has been transferred to the customer?

Answer

No. ASC 606-10-55-58B and 55-58C state, in part:

> An entity's promise to provide a customer with the right to use its intellectual property is satisfied at a point in time. The entity should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer.
>
> Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:
>
> a. An entity provides (**or otherwise makes available**) a copy of the intellectual property to the customer.
>
> b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (**or otherwise makes available**) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. [Emphasis added]

Entity X should consider the guidance on control in ASC 606-10-25-23 through 25-26 and the indicators in ASC 606-10-25-30 related to determining when a customer obtains control of the software license.

In some circumstances, control of the software license may be transferred to the customer before the access code or product key is delivered. In particular, there may be situations in which the access code or product key has not been delivered but is nonetheless made available to the customer at any time on demand. In such circumstances, it will be necessary to consider whether control has passed to the customer by focusing on the indicators in ASC 606-10-25-30. For example, if the customer has accepted the software, nonrefundable payment has been received, and the license term has begun, X may conclude that control of the software license has been transferred even though the access code or product key has not been provided to the customer. These situations may be viewed as analogous to bill-and-hold arrangements, as discussed in ASC 606-10-55-81 through 55-84.

If payment terms or acceptance depends on delivery of the software access code or product key, or if X is not yet in a position to make the code or key available, it would be unlikely that X could conclude that control of a software license has been transferred until the access code or product key has been provided to the customer.

Q&A 11-6 Electronic Delivery of Software — Assessing When Control Is Transferred to the Customer in a Hosting Arrangement

An entity may promise to provide a license to access its software via an online hosting arrangement. For example, Entity Y enters into a license and hosting software arrangement with Customer X that allows X to access via the Internet and use software that Y physically hosts on its servers. Customer X is required to pay a nonrefundable license fee of $1,000 at the inception of the arrangement. Customer X accepts the software, and the license term begins once the hosting service commences.

As part of the arrangement, X has the right to take possession of the software at any time during the contract period without incurring additional costs or diminution of the software's utility or value. That is, there are no contractual or practical barriers to X's exercising its right to take possession of the software, and X is able to benefit from the software on its own or with readily available resources.

Entity Y concludes that the software license and hosting service are each distinct and that the software license gives X a right to use Y's IP. If X exercises its right to take possession of the software, Y will immediately provide an access code that will enable X to download the software.

Question

When is control of the software license transferred to X?

Answer

In this scenario, X is required to pay the nonrefundable license fee at the inception of the arrangement; X has accepted the software and the license term begins once the hosting service commences; and Y has made the access code available to X at any time on demand. Therefore, assuming that no other indicators of control are present, it seems reasonable for Y to conclude that control of the software license is transferred to X when the license term and hosting service begin. As a result, the transaction price allocated to the license is recognized at inception of the arrangement (corresponding to its transfer of control at that point in time) and the transaction price allocated to the hosting service is recognized over time.

11.5.4 License Renewals

Changing Lanes — Timing of Revenue Recognition for License Renewals

Stakeholders questioned how entities should account for license renewals (or extensions of the license period). Specifically, they asked whether renewals (or extensions) result in the addition of a distinct license for which control is not transferred until the new (extended) license period begins, or whether the extended license period becomes part of the original license for which control may have already been transferred to the customer (if it is an extension of a license that is already controlled by the customer). For example, suppose that an entity provides a right-to-use license to its customer for a three-year period. After two years, the customer requests an extension of the license period for an additional two years, which results in the customer's right to use the license for a total of five years. Stakeholders questioned whether the entity providing the right-to-use license (i.e., a license for which revenue is recognized at a point in time) would recognize revenue at the point in time when the license term was extended (i.e., after two years) or at the point in time when the extension period began (i.e., the beginning of year 4).

As a result, the FASB included specific guidance in ASU 2016-10 to address stakeholders' concerns about right-to-use and right-to-access licenses. In accordance with that guidance, renewals or extensions of licenses should be evaluated as distinct licenses (i.e., a distinct good or service), and revenue attributed to the distinct good or service cannot be recognized until (1) the entity provides the distinct license (or makes the license available) to the customer and (2) the customer is able to use and benefit from the distinct license. In reaching this conclusion, the FASB observed that when two parties enter into a contract to renew a license, the renewal contract is not combined with the original license contract. Therefore, the renewal right should be evaluated in the same manner as any other additional rights granted after the initial contract (i.e., revenue should not be recognized until the customer can begin to use and benefit from the license, which is generally at the beginning of the license renewal period).

In addition to providing clarifying guidance in ASC 606-10-55-58C, the FASB provided the following additional example to clarify the timing of revenue recognition for renewals:

ASC 606-10

Example 59 — Right to Use Intellectual Property

[Case A omitted[5]]

Case B — Renewal of the License

55-392A At the end of the first year of the license period, on December 31, 20X1, the entity and the customer agree to renew the license to the recorded symphony for two additional years, subject to the same terms and conditions as the original license. The entity will continue to receive fixed consideration of $10,000 per month during the 2-year renewal period.

55-392B The entity considers the contract combination guidance in paragraph 606-10-25-9 and assesses that the renewal was not entered into at or near the same time as the original license and, therefore, is not combined with the initial contract. The entity evaluates whether the renewal should be treated as a new license or the modification of an existing license. Assume that in this scenario, the renewal is distinct. If the price for the renewal reflects its standalone selling price, the entity will, in accordance with paragraph 606-10-25-12, account for the renewal as a separate contract with the customer. Alternatively, if the price for the renewal does not reflect the standalone selling price of the renewal, the entity will account for the renewal as a modification of the original license contract.

55-392C In determining when to recognize revenue attributable to the license renewal, the entity considers the guidance in paragraph 606-10-55-58C and determines that the customer cannot use and benefit from the license before the beginning of the two-year renewal period on January 1, 20X3. Therefore, revenue for the renewal cannot be recognized before that date.

55-392D Consistent with Case A, because the customer's additional monthly payments for the modification to the license will be made over two years from the date the customer obtains control of the second license, the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

11.6 Sales- or Usage-Based Royalties

An entity may license its IP to a customer and in exchange receive consideration that may include fixed and variable amounts. Certain licensing arrangements require the customer to pay the entity a variable amount based on the underlying sales or usage of the IP (a "sales- or usage-based royalty"). As discussed in Chapter 6, the new revenue standard requires an entity to estimate and constrain variable consideration in a contract with a customer. The FASB and IASB decided to create an exception to the general model for consideration in the form of a sales- or usage-based royalty related to licenses of IP.

ASC 606-10

55-65 Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.
b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

[5] Case A of Example 59, on which Case B is based, is reproduced in Section 11.4 above.

Under the sales- or usage-based royalty exception to the new revenue standard's general rule requiring an entity to include variable consideration in the transaction price, if an entity is entitled to consideration in the form of a sales- or usage-based royalty, revenue is not recognized until (1) the underlying sales or usage has occurred and (2) the related performance obligation has been satisfied (or partially satisfied). That is, an entity is not required to estimate the amount of a sales- or usage-based royalty at contract inception; rather, revenue would be recognized as the subsequent sales or usage occurs (assuming that the associated performance obligation has been satisfied or partially satisfied).

ASC 606-10

55-65A The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

55-65B When the guidance in paragraph 606-10-55-65A is met, revenue from a sales-based or usage-based royalty should be recognized wholly in accordance with the guidance in paragraph 606-10-55-65. When the guidance in paragraph 606-10-55-65A is not met, the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14 applies to the sales-based or usage-based royalty.

TRG Update — Whether to Split a Sales- or Usage-Based Royalty

In some contracts, a single sales- or usage-based royalty may be related to both a license of IP and another good or service (i.e., not a license). After the new revenue standard was issued, stakeholders communicated that it is unclear whether a sales- or usage-based royalty should ever be split into a portion to which the sales- or usage-based royalty exception would apply and a portion to which the general constraint on variable consideration in step 3 would apply.

The TRG discussed this issue at its July 2014 meeting. TRG members generally expressed one of the following three views:

- *View A* — The sales- or usage-based royalty exception should apply whenever the royalty is related to a license, regardless of whether (1) the royalty is also related to another nonlicense good or service or (2) the license is a separate performance obligation.
- *View B* — The sales- or usage-based royalty exception should apply only when the royalty is solely related to a license and that license is a separate performance obligation.
- *View C* — The sales- or usage-based royalty exception should apply when (1) the royalty is solely related to a license of IP or (2) the royalty is related to a license and one or more other nonlicense goods or services, but the license is the primary or dominant component to which the royalty is related.

As a result of the TRG's discussion, the FASB issued ASU 2016-10 to clarify that an entity should not split a royalty into a portion that is subject to the sales- or usage-based royalty exception and a portion that is subject to the general constraint on variable consideration in step 3. ASU 2016-10 also clarifies that the sales- or usage-based royalty exception applies when the license is distinct or is the predominant item in a performance obligation with other nonlicense goods or services.

When applying the sales- or usage-based royalty exception, an entity generally would recognize revenue when (or as) the customer's subsequent sales or usage occurs. However, if the sales- or usage-based royalties accelerate revenue recognition as compared with the entity's satisfaction (or partial satisfaction) of the associated performance obligation, the entity may be precluded from recognizing some of all of the revenue as the subsequent sales or usage occurs.

Q&A 11-7 Interaction of Sales- or Usage-Based Royalty Exception With Measuring Progress Toward Satisfaction of a Performance Obligation to Transfer a License Over Time

Entity S, a sports team, enters into a noncancelable license agreement with Entity C, a clothing manufacturer, under which C can use the sports team's logo on the shirts it manufactures and sells. The license is a right to access S's IP and is transferred to C over time.

Scenario 1

The license is for a five-year period in exchange for a flat-rate royalty payable to S for every shirt sold. During the first year of the contract, a sporting competition is held. As a result of the sporting competition, the clothing manufacturer sells a much larger than normal number of shirts.

Scenario 2

The license arrangement is such that the first shirt sold triggers a royalty payment of $1 million to S and the next 999,999 units sold do not trigger any further royalty payments. Each sale in excess of 1 million items triggers a $1 royalty.

Question

If, as in the scenarios described, a license of IP is transferred to a customer over time and the associated sales- or usage-based royalty payments are higher at the start of the license period, should the recognition of revenue be deferred?

Answer

It depends. ASC 606-10-55-65 specifies that revenue for a sales- or usage-based royalty promised in exchange for a license of IP is recognized only when (or as) the **later** of the following events occurs:

a. The subsequent sale or usage occurs.
b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Accordingly, revenue should be deferred if, and to the extent that, recognition based on subsequent sales or usage (i.e., criterion (a)) is judged to be in advance of satisfaction of the performance obligation (i.e., criterion (b)). The determination of whether this is the case will depend on an analysis of the specific facts and circumstances. It will often be helpful to consider whether the structure of the royalty payments appropriately depicts progress toward satisfying the entity's performance obligation of providing access to the entity's IP throughout the license period. If the structure of the royalty payments does appropriately depict such progress, the criteria in ASC 606-10-55-65(a) and (b) will coincide, and no deferral of revenue will be necessary.

Whereas the amount determined under criterion (a) will be essentially a matter of fact (actual sales or usage multiplied by the applicable royalty rate), an entity will typically need to use judgment to determine the amount under criterion (b). In particular, it will be important in the scenarios described above for S to identify an appropriate measure of progress toward complete satisfaction of its obligation under the agreement in accordance with ASC 606-10-25-31. Entity S should then apply the guidance in ASC 606-10-55-65 to determine whether any revenue from royalties that have become payable on the basis of sales or usage exceeds the amount of revenue that S determined by applying the identified measure of progress. If so, S should defer that excess and recognize it as a contract liability.

Note that ASC 606-10-55-65 requires an entity to recognize revenue upon the occurrence of the **later** of the events described in ASC 606-10-55-65(a) and (b). Consequently, it is never possible to recognize revenue in advance of the amount payable under criterion (a) (actual sales or usage multiplied by the applicable royalty rate), even if royalty rates have been back-end loaded in such a way that royalties lag behind the measure of progress identified.

Scenario 1

In Scenario 1, S concludes that it is reasonable for the higher royalty payments in the first year of the license to reflect a higher proportion of the total license value being transferred to C in that year because C has sold a disproportionately large number of shirts. Accordingly, the structure of the royalty payments appropriately depicts progress toward satisfying S's performance obligation of providing access to its IP throughout the license period. It is unnecessary for S to defer any of the royalty payments received in year 1 over the remainder of the license term.

In this example, although the royalties payable are higher in the first year of the royalty arrangement, the magnitude of the royalty payments corresponds to greater value received by the customer in that year and, consequently, is still consistent with progress toward satisfaction of the performance obligation over time.

Scenario 2

In Scenario 2, S would be likely to conclude that the first royalty payment of $1 million corresponds to the benefit of the license being transferred for the first 1 million sales made by C. Accordingly, S would recognize the first royalty payment of $1 million over the period in which the first 1 million shirts are sold. For any sales made in excess of the first 1 million items, S would recognize the royalty payments of $1 per shirt sold upon the sale of each item because the structure of those subsequent royalty payments aligns with the transfer of the benefit of the license to C.

In this scenario, it would not be appropriate for S to recognize as revenue the entire $1 million royalty payment received when the first shirt is sold because that would not be a reasonable reflection of the progress toward satisfaction of S's performance obligation. Because the royalties have been front-end loaded in a way that does not reflect the value to the customer, the royalties that have become payable on the basis of sales or usage exceed the amount of revenue that S determined by applying an appropriate measure of progress. Therefore, revenue recognized is restricted to the latter.

See Q&A 11-8 for an illustration of variable royalty rates over the term of a license.

Q&A 11-8 Interaction of Sales- or Usage-Based Royalty Exception With Measuring Progress Toward Satisfaction of a Performance Obligation to Transfer a License Over Time — Example

Entity S, a sports team, enters into a noncancelable license agreement with Entity M, a manufacturer, under which M can use the sports team's logo on a product that it manufactures and sells. The license is a right to access S's IP and is transferred to the customer over time. The license is for a five-year period in exchange for a royalty for every product sold.

The royalty rate decreases during the term of the license: in years 1 through 3, M is required to pay 10 percent of the sales price of the product to S, whereas in years 4 and 5, M is required to pay 8 percent of the sales price of the product to S. The volume of product sales on which the royalty is based is expected to be approximately equal for each of the five years of the license.

To apply the guidance in ASC 606-10-55-65, S will need to determine an appropriate measure of progress toward satisfying the performance obligation over time. As discussed in Q&A 11-7, S may find it helpful to consider whether the structure of the royalty payments appropriately depicts progress toward satisfying its performance obligation to provide access to its IP throughout the license period.

Although the royalty rate decreases for the last two years of the license period, S might conclude that the structure of the royalty payments appropriately depicts progress toward satisfying its performance obligation if the change in rate reflects the decreased value of the license to M in those years. For example, this might be the case if M's product was expected to have a higher selling price in years 1 through 3 than in years 4 and 5; the reduction in royalty rate might have been intended to reflect the lower gross margins that M could expect in years 4 and 5 and, consequently, the lower value of the license to M in those years.

However, if the structure of the royalty payments does not appropriately depict progress toward satisfying S's performance obligation, S will need to determine an appropriate measure of progress and use this to apply the guidance in ASC 606-10-55-65. For example, because the volume of product sales is expected to be broadly flat, S may conclude that it is reasonable to regard the benefit of the license as being transferred to M on a straight-line basis over time. If so, S will need to develop an appropriate method for determining what amount of royalties received should be deferred to meet the requirements of ASC 606-10-55-65.

The sales- or usage-based royalty exception is limited to narrow circumstances in which the entity licenses its IP. Stakeholders have questioned the scope of the sales- or usage-based royalty recognition constraint in arrangements that are economically similar but legally different.

Q&A 11-9 Scope of the Sales- or Usage-Based Royalty Exception

Question

Is there a difference in the accounting for a sale of IP and a license of IP promised in exchange for a sales- or usage-based royalty?

Answer

Yes. The sales- or usage-based royalty exception in ASC 606-10-55-65 should be applied by the licensor when accounting for the transfer of a **license of IP promised in exchange for a sales- or usage-based royalty**; a sale of IP does not qualify for the exception and, accordingly, would be accounted for under the general revenue measurement and recognition guidance in ASC 606.

The FASB and IASB decided against applying the exception for sales- or usage-based royalties to IP more broadly. As indicated in paragraph BC421 of ASU 2014-09, the boards believed that although the exception "might not be consistent with the principle of recognizing some or all of the estimate of variable consideration," the disadvantage of such an inconsistency in these limited circumstances is "outweighed by the simplicity of [the exception's requirements], as well as by the relevance of the resulting information for this type of transaction." Further, the boards concluded that the exception should not be applied "by analogy to other types of promised goods or services or other types of variable consideration." The boards' full rationale for their decision is set out in paragraphs BC415 through BC421 of ASU 2014-09.

Example 1

Entity X provides its customer with a license to broadcast one of X's movies on the customer's networks in exchange for a royalty of $10,000, which is payable each time the movie is broadcasted over the five-year license period. Entity X considers the guidance in ASC 606-10-55-59 through 55-64A and concludes that X has promised to its customer a right to use X's IP (i.e., X has satisfied its performance obligation at the point in time at which the customer is able to use and benefit from the license).

Entity X applies the requirements of ASC 606-10-55-65 and does not recognize any revenue when the license is transferred to the customer. Instead, X recognizes revenue of $10,000 each time the customer uses the licensed IP and broadcasts X's movie.

Example 2

Entity X sells the copyright to one of its music albums (i.e., all rights related to the IP) to a customer in exchange for a promise of future payments equal to $1 for each album sold by the customer in the future and $0.01 for each time a song on the album is played on the radio. Entity X considers the guidance in ASC 606-10-25-23 through 25-30 and determines that its performance obligation is satisfied at the point in time at which it transfers the copyright to the customer.

In accordance with ASC 606-10-32-2 and 32-3, upon transferring control of the IP to the customer, X recognizes revenue equal to its estimate of the amount to which it will be entitled, subject to the constraint on variable consideration specified by ASC 606-10-32-11 and 32-12. Entity X then updates its estimate and records a cumulative catch-up adjustment at each subsequent reporting period as required by ASC 606-10-32-14.

Q&A 11-10 Fixed-Value Royalty Payments for a License of IP Receivable on Reaching a Sales- or Usage-Based Milestone

In many industries, it is common for contracts related to a license of IP to include payment terms tied to milestones ("milestone payments"). These milestone payments are frequently structured in such a way that entitlement to or payment of an amount specified in the contract is triggered once a sales target (i.e., a specified level of sales) has been reached (e.g., a $10 million milestone payment is triggered once cumulative sales by the licensee exceed $100 million).

Question

When should revenue with respect to such milestone payments be recognized?

Answer

Revenue with respect to such milestone payments should be recognized when the sales- or usage-based milestone is reached (or later if the related performance obligation has not been satisfied), as required by the exception for sales- or usage-based royalties set out in ASC 606-10-55-65. This requirement applies to milestone payments triggered by reference to sales- or usage-based thresholds even when the milestone amount to be paid is fixed.

However, this exception should **not** be applied to milestone payments related to the occurrence of any other event or indicator (e.g., regulatory approval or proceeding into a beta phase of testing).

Paragraph BC415 of ASU 2014-09 states, "The [FASB and IASB] decided that for a license of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize any revenue for the variable amounts until the uncertainty is resolved (that is, when a customer's subsequent sales or usage occurs)." This paragraph illustrates the boards' intent that the exception should apply to consideration only when the consideration is (1) related to licenses of IP and (2) based on the customer's subsequent sales or usage.

Q&A 11-11 Recognition of Sales-Based Royalties — Information Received From the Licensee After the End of the Reporting Period

In certain licensing arrangements for which the consideration received from the customer is based on the subsequent sales of IP, information associated with those subsequent sales may not be available before the end of the reporting period. For example, Entity A enters into a software license with Entity B that allows inclusion of the software in computers that B sells to third parties. Under the terms of the license, A receives royalties on the basis of the number of computers sold that include the licensed software. Upon delivery of the software to B, A satisfies the performance obligation to which the sales-based royalty was allocated. Thereafter, A receives quarterly sales data in arrears, which allows it to calculate the royalty payments due under the license.

Question

Should A recognize revenue (royalty payments) for computer sales made by B up to the end of its reporting period even though sales data had not been received at the end of that reporting period?

Answer

Yes. Provided that the related performance obligation has been satisfied (as is the case in this example), ASC 606-10-55-65 requires that sales-based royalties received for a license of IP be recognized when the subsequent sale or usage by the licensee occurs. It would not be appropriate to delay recognition until the sales information is received.

In this scenario, royalties should be recognized for sales made by B up to the end of A's reporting period on the basis of sales data received before A's financial statements are issued or available to be issued. If necessary, A should estimate sales made in any period not covered by such data. It would not be appropriate for entities to omit sales-based royalties from financial statements merely because the associated sales data were received after the end of the reporting period or were not received when the financial statements were issued or available to be issued.

Q&A 11-12 Application of the Sales- or Usage-Based Royalty Exception to Guaranteed Minimum Royalties

As discussed in Chapter 6, an entity is required to estimate (and constrain) variable consideration and recognize the consideration in revenue when (or as) it satisfies its performance obligations. However, as previously noted in Section 11.6, if the contract includes consideration in the form of a sales- or usage-based royalty in exchange for a license of IP, the entity would be required to apply the guidance in ASC 606-10-55-65, which constitutes an exception to the variable consideration guidance. Under that exception, the entity would recognize revenue at the later of when (1) the "subsequent sale or usage occurs" or (2) the "performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)."

In addition, entities may enter into royalty arrangements in which the customer agrees to pay a sales- or usage-based royalty that includes a guaranteed minimum amount of royalties.

Question

Does the exception to the "constraint" for sales- or usage-based royalties in a license of IP apply to the guaranteed minimum portion of a royalty fee?

Answer

No. However, the exception to the constraint for sales- or usage-based royalties in a license of IP would apply to any variable consideration that exceeds the fixed portion. That is, if the licensee's sales or usage could potentially affect the amount of royalties (consideration) the entity receives, the exception would apply.

Q&A 11-13 Application of the Sales- or Usage-Based Royalty Exception to a Variable Royalty Arrangement With Declining Royalties

An entity may enter into a contract with a customer in which the parties agree to a variable royalty arrangement with declining royalties. Consider the following example:

Example

An entity enters into a contract to provide a vendor (the "customer") with a noncancelable license to the entity's IP. The entity determines that the license is a right-to-use license (i.e., a license for which revenue is recognized at a point in time) for a three-year period. The customer's estimated sales are expected to be approximately equal for each of the three years under license. For the use of the IP, the agreement requires the customer to pay the entity a royalty of 10 percent of the customer's sales in year 1, 8 percent of the customer's sales in year 2, and 6 percent of the customer's sales in year 3.

Question

In the example above, should the entity account for the royalty payments by using the general model, which requires estimates of variable consideration?

Answer

No. The entity should account for the royalty payments in a manner consistent with the legal form of the arrangement and in accordance with the exception to the variable consideration guidance for licenses of IP that include a sales- or usage-based royalty. Consequently, the entity would include the royalties in the transaction price on the basis of the applicable contractual rate and the customer's sales in each year and then, in accordance with ASC 606-10-55-65, recognize revenue at the later of when (1) the "subsequent sale or usage occurs" or (2) the "performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)."

ASC 606-10

Example 60 — Sales-Based Royalty Promised in Exchange for a License of Intellectual Property and Other Goods and Services

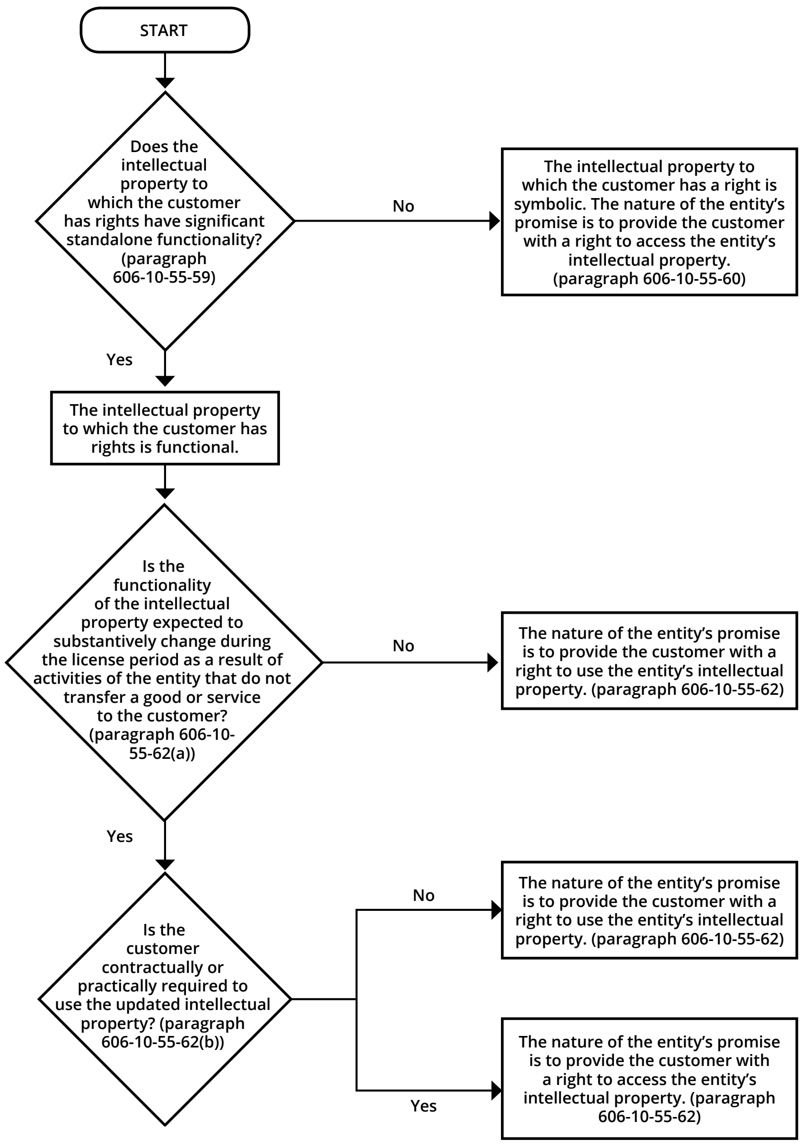
55-393 An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week airing period and to sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week airing period. In exchange for providing the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (that is, variable consideration in the form of a sales-based royalty).

55-394 The entity concludes that the license to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the related promotional goods or services. The entity will recognize revenue from the sales-based royalty, the only fees to which the entity is entitled under the contract, wholly in accordance with paragraph 606-10-55-65. If the license, the memorabilia, and the advertising activities were separate performance obligations, the entity would allocate the sales-based royalties to each performance obligation.

11.7 Additional Flowchart and Example for Determining the Nature of a License

The flowchart below, which is reproduced from ASC 606-10-55-63A, provides an overview of the decision-making process for determining the nature of an entity's license of IP to a customer (i.e., for determining whether a license of IP is a right to use or right to access an entity's IP). Note, however, that the flowchart does not include all of the guidance an entity is required to consider and is not intended to be a substitute for the guidance discussed above.

ASC 606-10



The example below, which is reproduced from ASC 606, further illustrates the application of the licensing implementation guidance discussed above.

ASC 606-10

Example 57 — Franchise Rights

55-375 An entity enters into a contract with a customer and promises to grant a franchise license that provides the customer with the right to use the entity's trade name and sell the entity's products for 10 years. In addition to the license, the entity also promises to provide the equipment necessary to operate a franchise store. In exchange for granting the license, the entity receives a fixed fee of $1 million, as well as a sales-based royalty of 5 percent of the customer's sales for the term of the license. The fixed consideration for the equipment is $150,000 payable when the equipment is delivered.

Identifying Performance Obligations

55-376 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the entity, as a franchisor, has developed a customary business practice to undertake activities such as analyzing the consumers' changing preferences and implementing product improvements, pricing strategies, marketing campaigns, and operational efficiencies to support the franchise name. However, the entity concludes that these activities do not directly transfer goods or services to the customer.

55-377 The entity determines that it has two promises to transfer goods or services: a promise to grant a license and a promise to transfer equipment. In addition, the entity concludes that the promise to grant the license and the promise to transfer the equipment are each distinct. This is because the customer can benefit from each good or service (that is, the license and the equipment) on its own or together with other resources that are readily available (see paragraph 606-10-25-19(a)). The customer can benefit from the license together with the equipment that is delivered before the opening of the franchise, and the equipment can be used in the franchise or sold for an amount other than scrap value. The entity also determines that the promises to grant the franchise license and to transfer the equipment are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b). The entity concludes that the license and the equipment are not inputs to a combined item (that is, they are not fulfilling what is, in effect, a single promise to the customer). In reaching this conclusion, the entity considers that it is not providing a significant service of integrating the license and the equipment into a combined item (that is, the licensed intellectual property is not a component of, and does not significantly modify, the equipment). Additionally, the license and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfill each promise (that is, to license the franchise or to transfer the equipment) independently of the other. Consequently, the entity has two performance obligations:

a. The franchise license
b. The equipment.

Allocating the Transaction Price

55-378 The entity determines that the transaction price includes fixed consideration of $1,150,000 and variable consideration (5 percent of the customer's sales from the franchise store). The standalone selling price of the equipment is $150,000 and the entity regularly licenses franchises in exchange for 5 percent of customer sales and a similar upfront fee.

55-379 The entity applies paragraph 606-10-32-40 to determine whether the variable consideration should be allocated entirely to the performance obligation to transfer the franchise license. The entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the franchise license because the variable consideration relates entirely to the entity's promise to grant the franchise license. In addition, the entity observes that allocating $150,000 to the equipment and allocating the sales-based royalty (as well as the additional $1 million in fixed consideration) to the franchise license would be consistent with an allocation based on the entity's relative standalone selling prices in similar contracts. Consequently, the entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the performance obligation to grant the franchise license.

ASC 606-10 (continued)

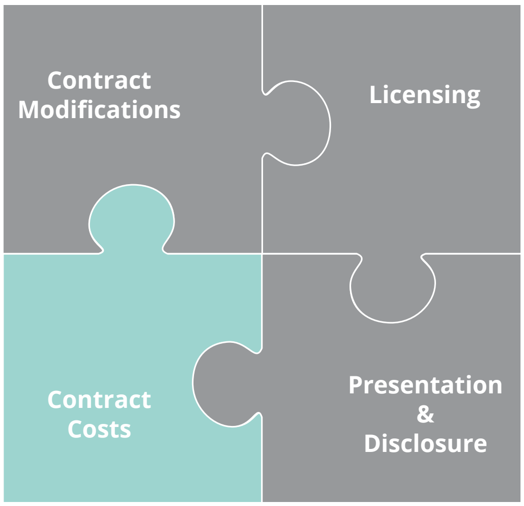
Licensing

55-380 The entity assesses the nature of the entity's promise to grant the franchise license. The entity concludes that the nature of its promise is to provide a right to access the entity's symbolic intellectual property. The trade name and logo have limited standalone functionality; the utility of the products developed by the entity is derived largely from the products' association with the franchise brand. Substantially all of the utility inherent in the trade name, logo, and product rights granted under the license stems from the entity's past and ongoing activities of establishing, building, and maintaining the franchise brand. The utility of the license is its association with the franchise brand and the related demand for its products. . . .

55-381 The entity is granting a license to symbolic intellectual property. Consequently, the license provides the customer with a right to access the entity's intellectual property and the entity's performance obligation to transfer the license is satisfied over time in accordance with paragraph 606-10-55-58A. The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraph 606-10-55-58A and paragraph 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license (see paragraph 606-10-55-382).

55-382 Because the consideration that is in the form of a sales-based royalty relates specifically to the franchise license (see paragraph 606-10-55-379), the entity applies paragraph 606-10-55-65 in recognizing that consideration as revenue. Consequently, the entity recognizes revenue from the sales-based royalty as and when the sales occur. The entity concludes that recognizing revenue resulting from the sales-based royalty when the customer's subsequent sales occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed $1 million franchise fee plus recognition of the periodic royalty fees as the customer's subsequent sales occur reasonably depict the entity's performance toward complete satisfaction of the franchise license performance obligation to which the sales-based royalty has been allocated.

Chapter 12 — Contract Costs



12.1 Introduction

ASC 340-40

05-1 This Subtopic provides accounting guidance for the following costs related to a contract with a customer within the scope of Topic 606 on revenue from contracts with customers:

a. Incremental costs of obtaining a contract with a customer

b. Costs incurred in fulfilling a contract with a customer that are not in the scope of another Topic.

Initially, the intent of the FASB and IASB was to create a standard on revenue; however, because the new revenue standard superseded substantially all of ASC 605-35 (formerly SOP 81-1), which integrated revenue, cost, and margin guidance, the boards needed to address the gaps created by the superseding of guidance on revenue and certain contract costs. Accordingly, ASC 340-40 introduces comprehensive guidance on (1) accounting for costs of obtaining a contract within the scope of ASC 606 (see Section 12.2), and (2) provides guidance on how to account for costs of fulfilling a contract with a customer that are not within the scope of another standard (see Section 12.3).

The new standard under U.S. GAAP includes cost guidance separately in ASC 340-40 and not in ASC 606; however, IFRS 15 includes both revenue and cost guidance. In developing this cost guidance, the boards did not intend to holistically reconsider cost accounting. Rather, they aimed to fill gaps resulting from the superseding of guidance on revenue (and certain contract costs) and promote convergence between U.S. GAAP and IFRSs. The boards also wanted to improve consistency in the application of certain cost guidance. For example, under current U.S. GAAP, entities may not consistently capitalize direct and incremental costs associated with obtaining a contract. Although certain current guidance may be applied by analogy to allow such costs to be capitalized, entities are often permitted to expense direct and incremental costs of obtaining a contract as incurred. The new guidance in ASC 340-40 will eliminate this diversity by requiring incremental costs of obtaining a contract to be capitalized when such costs are expected to be recovered.

Often, costs specific to a contract will be incurred by an entity before the entity has a contract with a customer (e.g., precontract costs). When considering how to account for precontract costs, entities should be mindful that such costs may include both costs of obtaining a contract and costs of fulfilling a contract, and that the requirements with respect to each are different.

Changing Lanes — Impact of the New Cost Guidance

Current guidance under U.S. GAAP does not contain a comprehensive cost framework for either costs to obtain a contract or costs to fulfill a contract. In contrast, although the FASB and IASB did not initially intend to comprehensively address cost guidance in the new revenue standard, the final standard does in fact establish a single cost model for costs to obtain a contract (sometimes referred to as initial direct costs, incremental direct acquisition costs, or contract acquisition costs) for contracts within the scope of the new revenue standard.

While ASC 605-20 (formerly FASB Technical Bulletin 90-1) on separately priced extended warranties and ASC 310-20 (formerly FAS 91) on accounting for loan origination costs and fees both provide specific guidance on certain costs incurred to obtain a contract, existing guidance in U.S. GAAP does not otherwise provide broad guidance on accounting for the costs of obtaining a contract. Therefore, when accounting for costs outside the scope of these two pieces of guidance, an entity could elect to apply that guidance by analogy and capitalize some costs of obtaining a contract. However, in arrangements outside the scope of the noted guidance, expensing of such costs has been broadly accepted under current U.S. GAAP.

Even entities that have analogized to the guidance in ASC 605-20 or ASC 310-20 and capitalized costs of obtaining a revenue contract should carefully evaluate the pool of eligible costs in light of the new requirements discussed below. That is, regardless of an entity's prior policies with respect to the costs of obtaining a contract (i.e., capitalize or expense), there could be changes upon adoption of the new revenue standard. In addition, there are transition considerations that an entity should carefully evaluate (see Chapter 15 for further discussion).

Also, as further discussed below, while the changes in the accounting for the costs of fulfilling a contract may not affect every entity, some entities may experience a change. For example, entities that apply ASC 605-35 (formerly SOP 81-1) will most likely have to reevaluate whether the capitalization of certain contract costs related to construction and other long-term contracts (such as precontract bid and proposal costs) remains appropriate under the new revenue standard. Also, all entities should carefully consider what guidance is applicable to each of their contracts to ensure that the guidance will or will not affect them.

12.2 Costs of Obtaining a Contract

ASC 340-40

15-2 The guidance in this Subtopic applies to the incremental costs of obtaining a contract with a customer within the scope of Topic 606 on revenue from contracts with customers (excluding any consideration payable to a customer, see paragraphs 606-10-32-25 through 32-27).

ASC 340-40 provides an overall, comprehensive framework to account for costs of obtaining a contract that are within the scope of ASC 606. That is, if a contract falls within the scope of ASC 606, an entity should look to ASC 340-40 for all relevant guidance on costs of obtaining the contract.

Specifically, ASC 340-40 provides the following guidance on recognizing the incremental costs of obtaining a contract with a customer:

ASC 340-40

25-1 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

25-2 The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

25-3 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

Commissions are often cited as an example of an incremental cost to obtain the contract. However, the boards acknowledged that it may be difficult for an entity to determine whether a commission paid was incremental to obtaining the new contract, and they considered permitting a policy election consistent with existing U.S. GAAP that would allow an entity to choose to recognize the acquisition costs as either an asset or an expense. However, such an election would be contrary to the goal of increasing comparability, which is one of the key objectives of the new revenue standard; therefore, the boards ultimately decided not to allow an accounting policy election for costs of obtaining a contract.

See Section 13.4.2 for a Q&A addressing presentation of contract costs.

Construction Ahead — Treatment of Asset Manager Costs

The FASB noted that the treatment of sales commissions paid to third-party brokers in arrangements between asset managers and other parties may vary depending on the facts and circumstances of the arrangement (i.e., the commission would be recognized in some cases as an expense and in other cases as an asset). This outcome was not the FASB's intent; therefore, the Board decided to retain specific cost guidance for investment companies in ASC 946-605-25-8, which has been moved to ASC 946-720. Further, the FASB has proposed a technical correction to align the cost capitalization guidance in ASC 946 for advisers to both public funds and private funds (see Chapter 19).

12.2.1 Practical Expedient

ASC 340-40

25-4 As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

If an entity elects the practical expedient to expense incremental costs of obtaining a contract when incurred because the amortization period of the asset would have been one year or less, the entity is also required, under ASC 606-10-50-22, to disclose such election. In addition, the practical expedient should be applied consistently to contracts with similar characteristics and in similar circumstances.

The Q&As below address the application of the practical expedient to expense contract costs.

Q&A 12-1 Whether the Practical Expedient in ASC 340-40-25-4 for Expensing Contract Acquisition Costs Must Be Applied to All Contracts

Question

If an entity wishes to apply the practical expedient in ASC 340-40-25-4 to expense contract acquisition costs that would be amortized over a period of less than one year, is it required to apply that practical expedient to all of its contracts?

Answer

No. The practical expedient in ASC 340-40-25-4 to expense contract acquisition costs that would be amortized over a period of less than one year needs to be applied consistently to contracts with similar characteristics and in similar circumstances in accordance with ASC 606-10-10-3. Therefore, if an entity has contracts with dissimilar characteristics or dissimilar circumstances, it can choose for each class of contract whether to apply the expedient.

The identification of contracts with similar characteristics and the evaluation of similar circumstances should be performed as an entity-wide assessment. An entity with multiple subsidiaries or business units that operate in multiple jurisdictions might identify that different subsidiaries or business units have contracts with dissimilar characteristics or dissimilar circumstances.

Q&A 12-2 Applying the Practical Expedient in ASC 340-40-25-4 (Recognizing the Costs of Obtaining a Contract as an Expense When Incurred)

ASC 340-40-25-1 requires an entity to capitalize as an asset the incremental costs of obtaining a contract with a customer if those costs are expected to be recovered, and ASC 340-40-35-1 requires an entity to amortize that asset "on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates."

Further, ASC 340-40-25-4 provides a practical expedient that allows an entity to expense those costs as incurred if the amortization period for the costs that would otherwise have been capitalized is one year or less.

Question 1

Is an entity permitted to apply the practical expedient in ASC 340-40-25-4 selectively on a contract-by-contract basis?

Answer

No. An entity is required to apply the practical expedient in ASC 340-40-25-4 consistently to contracts with similar characteristics and in similar circumstances in accordance with ASC 606-10-10-3.

Therefore, if an entity has contracts with dissimilar characteristics or dissimilar circumstances, it can choose for each class of contract whether to apply the expedient, but it is not permitted to apply the practical expedient selectively on a contract-by-contract basis.

Question 2

Can an entity apply the practical expedient in ASC 340-40-25-4 to some costs attributable to performance obligations in a contract but not others?

Answer

No. The incremental costs of obtaining a contract that are required to be capitalized in accordance with ASC 340-40-25-1 are related to the contract as a whole; the capitalized costs of obtaining a contract form a single asset even if the contract contains more than one performance obligation. Therefore, if the practical expedient in ASC 340-40-25-4 is applied, it should be applied to the contract as a whole. The practical expedient is available only if the amortization period of the entire asset that the entity otherwise would have recognized is one year or less.

Q&A 12-3 Amortization of Incremental Costs of Obtaining a Contract — Allocation Among Performance Obligations — Example

Entity B enters into a contract with a customer to provide the following:

- Product X delivered at a point in time.
- Maintenance of Product X for one year.
- An extended warranty on Product X that covers years 2 and 3 (Product X comes with a one-year statutory warranty).

Each of the elements is determined to be a separate performance obligation.

A sales commission of $200 is earned by the salesperson. This represents $120 for the sale of Product X (payable irrespective of whether the customer purchases the maintenance or extended warranty) and an additional $40 each for the sale of the maintenance contract and the sale of the extended warranty ($80 commission for the sale of both).

The commission is determined to meet the definition of an incremental cost of obtaining the contract in ASC 340-40-25-2 and it is therefore capitalized in accordance with ASC 340-40-25-1.

In this fact pattern, the entity cannot elect the practical expedient in ASC 340-40-25-4 to expense costs as incurred because the amortization period of the asset that the entity would recognize is more than one year (i.e., the extended warranty performance obligation included in the contract is for three years). The entity may, however, determine that it is appropriate to attribute the asset created by the commission to the individual performance obligations and record amortization of the asset in an amount that corresponds to the revenue recognized as each good or service is transferred to the customer.

12.2.2 Implementation Example From ASC 340-40

The following example from ASC 340-40 further illustrates the application of the new revenue standard's guidance on accounting for incremental costs of obtaining a contract:

ASC 340-40

Example 1 — Incremental Costs of Obtaining a Contract

55-2 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$	15,000
Travel costs to deliver proposal		25,000
Commissions to sales employees		10,000
Total costs incurred	$	50,000

55-3 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

55-4 The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

TRG Update — Applying the New Cost Guidance to Sales Commissions Paid to Obtain Contracts With Customers

Because many entities pay sales commissions to obtain contracts with customers, questions have arisen regarding how to apply the new revenue standard's cost guidance to such commissions, including:

- Whether certain commissions (e.g., commissions on contract renewals or modifications, commission payments that are contingent on future events, and commission payments that are subject to "clawback" or thresholds) qualify as assets.
- The types of costs to capitalize (e.g., whether and, if so, how an entity should consider fringe benefits such as payroll taxes, pension, or 401(k) match) in determining the amount of commissions to record as incremental costs.
- The pattern of amortization for assets related to multiple performance obligations (e.g., for contract cost assets related to multiple performance obligations that are satisfied over disparate points or periods of time).

At their January 2015 meeting, TRG members generally agreed that entities would continue to first refer to existing GAAP on liability recognition to determine whether and, if so, when a liability from a contract with a customer needs to be recorded. For example, an entity would apply the specific GAAP on liability (e.g., commissions, payroll taxes, 401(k) match) and then determine whether to record the related debit as an asset or expense.

TRG members also noted that there is no need for prescriptive guidance on amortization periods and methods and that the new revenue standard is clear that (1) an entity should amortize the asset on a systematic basis and (2) the method should reflect the pattern of transfer of goods or services to a customer to which the asset relates. That is, the asset should be amortized in a manner that reflects the benefit (i.e., revenue) generated from the asset.

12.2.3 Determining When to Recognize Incremental Costs

The Q&A below discusses how an entity should determine when to recognize the incremental costs of obtaining a contract.

Q&A 12-4 Recognition of Incremental Costs of Obtaining a Contract

Arrangements for the payment of some incremental costs of obtaining a contract may be complex. For example, payment of a sales commission may be (1) contingent on a future event, (2) subject to clawback, or (3) based on achieving cumulative targets.

Question

How should an entity determine when to recognize the incremental costs of obtaining a contract?

Answer

The new revenue standard does not address this issue. Other Codification topics (e.g., ASC 275, ASC 710, ASC 712, ASC 715, and ASC 718) specify when a liability for costs should be recognized and how that liability should be measured.

If an entity concludes that a liability for incremental costs of obtaining a contract should be recognized under the relevant Codification topic, the guidance in ASC 340-40-25-1 should be applied to determine whether those recognized costs should be capitalized as an asset or recognized immediately as an expense.

The TRG discussed this issue in January 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 25. For additional information and Deloitte's summary, see Appendixes D and E.

12.3 Costs of Fulfilling a Contract

ASC 340-40

15-3 The guidance in this Subtopic applies to the costs incurred in fulfilling a contract with a customer within the scope of Topic 606 on revenue from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory
b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements
c. Subtopic 350-40 on internal-use software
d. Topic 360 on property, plant, and equipment
e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

ASC 340-40

25-5 An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

a. **The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).**
b. **The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.**
c. **The costs are expected to be recovered.**

25-6 For costs incurred in fulfilling a contract with a customer that are within the scope of another Topic (for example, Topic 330 on inventory; paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements; Subtopic 350-40 on internal-use software; Topic 360 on property, plant, and equipment; or Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed), an entity shall account for those costs in accordance with those other Topics or Subtopics.

25-7 Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
b. Direct materials (for example, supplies used in providing the promised services to a customer)
c. Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)
d. Costs that are explicitly chargeable to the customer under the contract
e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

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).

The new revenue standard does not modify accounting for fulfillment costs that are addressed by other applicable U.S. GAAP, but it does create new guidance on fulfillment costs that are outside the scope of other Codification topics, including costs related to certain preproduction activities (i.e., those not covered by other applicable standards).

Because the FASB and IASB did not intend to reconsider cost guidance altogether, the new revenue standard focuses on costs of fulfilling a contract that are not within the scope of another standard. Accordingly, if costs are within the scope of another standard and that standard requires them to be expensed, it is not possible to argue that they should be capitalized in accordance with ASC 340-40. Further, only costs directly related to a contract or anticipated contract with a customer are within the scope of ASC 340-40. Costs not directly related to a contract or anticipated (specified) contract should not be evaluated for capitalization under ASC 340-40.

The boards' intent in developing this guidance was to develop a clear objective for recognizing and measuring an asset arising from the costs to fulfill a contract; therefore, the boards decided that the costs must be directly related to a contract or anticipated contract to be included in the cost of the asset.

Driving Discussion — Accounting for Costs Incurred for an Anticipated Contract

Stakeholders have questioned whether costs incurred for an anticipated contract (e.g., costs for design and development or nonrecurring engineering) (1) would be within the scope of ASC 340 and therefore could be capitalized or (2) should be expensed in accordance with ASC 730. This issue is similar to the TRG's discussion of preproduction activities (see the related TRG Update — Costs Related to Preproduction Activities in Section 12.3.4); however, the costs incurred for an anticipated contract would pertain to a contract that is not yet obtained and whose terms might not yet be known. Factors for an entity to consider in determining whether the costs should be capitalized include, but are not limited to, (1) the likelihood or certainty that the entity will obtain the contract, (2) the likelihood that the costs will be recovered under the specific anticipated contract, (3) whether the costs create or enhance an asset that will be transferred to the customer once the entity obtains the contract (such costs could be capitalizable under other guidance), and (4) whether the costs are considered to be costs associated with research and development and would therefore be within the scope of ASC 730 and expensed as incurred. An entity will need to carefully consider the facts and circumstances of the arrangement in determining the appropriate treatment of costs incurred before a contract was obtained.

12.3.1 Variable Consideration and Uncertain Transaction Price

As noted above, an entity would need to be able to demonstrate whether any capitalized costs are recoverable. That is, the entity's contract with a customer needs to generate sufficient profit to recover any capitalized costs. Otherwise, no asset should be recorded or a recorded asset would be impaired (see Section 12.4 below).

Questions may arise about how to evaluate whether an asset is recoverable from a contract when the contract includes variable consideration and the transaction price (and therefore profit under the contract) may be subject to uncertainty. This situation is discussed in the Q&A below.

Q&A 12-5 Deferral of Costs When Variable Consideration Is Fully or Partially Constrained

When an entity enters into a contract with a customer to provide goods or services for variable consideration and the transaction price is fully or partially constrained at the time the customer obtains control of the goods or services, the entity may incur an up-front loss until the uncertainty associated with the variable consideration is resolved. That is, the amount of the asset(s) derecognized or fulfillment costs recognized exceeds the amount of revenue to be recognized on the date the entity satisfies its performance obligation(s) because of the application of the constraint on variable consideration.

Question

Can an entity defer costs associated with transferred goods or services in a contract when variable consideration is fully or partially constrained?

Answer

No. An entity should expense costs that are not eligible for capitalization under other authoritative literature (e.g., ASC 330 on inventory; ASC 360 on property, plant, and equipment; or ASC 985-20 on costs of software to be sold, leased, or otherwise marketed) unless (1) such costs meet the criteria to be capitalized in accordance with ASC 340-40[1] or (2) the resolution of an uncertainty giving rise to the constraint on variable consideration will result in the entity's recovery of an asset (e.g., a sales return).

In assessing whether costs meet the criteria to be capitalized as fulfillment costs, an entity should consider the guidance in ASC 340-40-25-5, which states that an entity should recognize an asset from the costs incurred to fulfill a contract only if **all** of the following criteria are met:

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.

c. The costs are expected to be recovered.

Since costs attributed to a satisfied performance obligation do not generate or enhance resources that that the entity will use in satisfying, or continuing to satisfy, future performance obligations, such costs do not meet criterion (b) and would not be eligible for capitalization under ASC 340-40.

Example

Entity A, a manufacturer, sells goods to Customer B, a distributor, for resale to B's customers. The manufacturer is required to recognize revenue when, after consideration of the indicators of control in ASC 606-10-25-30, it determines that control of goods has been transferred to the distributor.

Entity A enters into a contract with B to sell goods with a cost basis of $180,000 for consideration of $200,000. However, the goods have a high risk of obsolescence, which may cause A to provide rebates or price concessions to B in the future (i.e., the transaction price is variable). The contract does not include a provision for product returns, and A does not expect to accept any return of obsolete goods.

Entity A adjusts (i.e., constrains) the transaction price and concludes that $170,000 is the amount of consideration that is probable of not resulting in a significant revenue reversal. When control of the goods is transferred to B, A recognizes revenue of $170,000 (the constrained transaction price) and costs of $180,000. As a result, A incurs a loss of $10,000.

The TRG discussed this issue in March 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 34. For additional information and Deloitte's summary, see Appendixes D and E.

[1] ASC 340-40-25-6 indicates that when costs incurred to fulfill a contract with a customer are within the scope of any other Codification topics or subtopics, such costs should be accounted for in accordance with those other topics or subtopics.

12.3.2 Initial Losses and Expected Future Profits

Questions arise about whether losses incurred on an initially satisfied performance obligation can be capitalized when an entity is expected to generate profits on the sale of optional goods or services to a customer. This scenario is illustrated in the Q&A below.

Q&A 12-6 Initial Sales Made at a Loss in the Expectation of Generating Future Profitable Sales

Entity E's business model includes the sale of (1) equipment and (2) parts needed to maintain that equipment. It is possible for customers to source parts from other suppliers, but the regulatory environment in which E's customers operate is such that customers will almost always choose to purchase parts from E (the original equipment manufacturer). The spare parts are needed for the equipment to properly function for its expected economic life.

Entity E's business model is to sell the equipment at a significantly discounted price (less than the cost to manufacture the equipment) when E believes that doing so is likely to secure a profitable stream of parts sales. This initial contract is only for the equipment; it does not give E any contractual right to insist that customers subsequently purchase any parts. However, E's historical experience indicates that (1) customers will virtually always subsequently purchase parts and (2) the profits on the parts sales will more than compensate for the discount given on the equipment.

The equipment has a cost of $200 and would usually be sold for a profit. However, the equipment is sold at a discounted price of $150 if subsequent parts sales are expected.

Question

When the equipment is sold for $150, is E permitted to defer an element of the cost of $200 to reflect its expectation that this sale will generate further, profitable sales in the future?

Answer

No. In accordance with ASC 340-40-25-6, when the costs of fulfilling a contract are within the scope of another standard, they should be accounted for in accordance with that standard. In the circumstances described, the cost of $200 is within the scope of ASC 330, and must be expensed when the equipment is sold. Further, ASC 340-40-25-8(c) requires "[c]osts that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)" to be expensed when incurred.

Although E expects customers to purchase additional parts that will give rise to future profits, those additional purchases are at the customer's option and are not part of the contract to sell the equipment. Since E has satisfied its obligation to deliver the equipment, it is required to recognize revenue of $150 and the $200 cost in full.

Consequently, a loss of $50 arises on the initial sale of the equipment.

TRG Update — Expected Profit on Optional Future Purchases

TRG members discussed scenarios in which an entity sells goods or services to a customer at a loss with a strong expectation of profit on future orders from that customer (e.g., exclusivity or sole provider contractual terms). TRG members agreed that if those further purchases are optional, the underlying goods or services would not be considered promised goods or services in the initial contract with the customer; rather, any such options would be evaluated for the existence of a material right. For further discussion, see Section 5.6.

12.3.3 Implementation Example From ASC 340-40

The following example from ASC 340-40 further illustrates the application of the cost capitalization guidance:

ASC 340-40

Example 2 — Costs That Give Rise to an Asset

55-5 An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a $10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

Incremental Costs of Obtaining a Contract

55-6 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided. The entity amortizes the asset over seven years in accordance with paragraph 340-40-35-1 because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

Costs to Fulfill a Contract

55-7 The initial costs incurred to set up the technology platform are as follows:

Design services	$ 40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	100,000
Total costs	$ 350,000

55-8 The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

a. Hardware costs — accounted for in accordance with Topic 360 on property, plant, and equipment
b. Software costs — accounted for in accordance with Subtopic 350-40 on internal-use software
c. Costs of the design, migration, and testing of the data center — assessed in accordance with paragraph 340-40-25-5 to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.

ASC 340-40 (continued)

55-9 In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 340-40-25-5(b)). Therefore, the costs do not meet the criteria in paragraph 340-40-25-5 and cannot be recognized as an asset using this Topic. In accordance with paragraph 340-40-25-8, the entity recognizes the payroll expense for these two employees when incurred.

12.3.4 Contracts Satisfied Over Time

ASC 340-40-25-8(c) requires that fulfillment costs attributed to satisfied (or partially satisfied) performance obligations are to be expensed as incurred. Although current U.S. GAAP might allow for revenue and cost of revenue to be accounted for concurrently, particularly in certain long-term construction- and production-type contracts, the new revenue standard requires fulfillment costs to be evaluated for expense or deferral independently of the recording of the associated revenue. This is illustrated in the Q&A below.

Q&A 12-7 Asset Recognition for Costs Incurred to Fulfill a Contract Satisfied Over Time

Entity X has entered into a contract that consists of a single performance obligation satisfied over time. The transaction price is $1,250, and the expected costs of fulfilling the contract are $1,000, resulting in an expected overall margin of 20 percent. Entity X has decided that it is appropriate to use an output method to measure its progress toward completion of the performance obligation.

As of the reporting date, X has incurred cumulative fulfillment costs of $360, all of which are related to performance completed to date. Using the output measure of progress, X determines that revenue with respect to performance completed to date should be measured at $405, resulting in a margin of approximately 11.1 percent for the work performed to date. The total expected costs of fulfilling the contract remain at $1,000.

Question

Given that the contract consists of a single performance obligation and the margin expected on the contract is 20 percent, can X recognize an asset (or defer costs) of $36 to adjust the margin on work performed to date to 20 percent?

Answer

No. ASC 340-40-25-8 lists certain costs incurred in fulfillment of the contract that must be expensed when incurred. As indicated in ASC 340-40-25-8(c), such costs include "[c]osts that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)." Accordingly, the $360 in cumulative fulfillment costs incurred should be expensed since all of these costs are related to performance completed to date.

As noted in ASC 606-10-25-31, the measure of progress used to recognize revenue for performance obligations satisfied over time is intended to depict the goods or services for which control has already been transferred to the customer. Recording an asset (e.g., work in progress) for costs of past performance would be inconsistent with the notion that control of the goods or services is transferred to the customer over time (i.e., as performance occurs).

However, any contract fulfillment costs incurred by an entity that are related to **future** performance (e.g., inventories and other assets that have not yet been used in the contract and are still controlled by the seller) would be recognized as assets if (1) they meet the conditions of a Codification topic or subtopic other than ASC 340-40 (e.g., ASC 330, ASC 350, ASC 360) or (2) they are outside the scope of a Codification topic or subtopic other than ASC 340-40 and meet all of the criteria in ASC 340-40-25-5.

In addition, note that if X had decided that it was appropriate to use cost as a measure of progress, X would have determined that the performance obligation is 36 percent complete (($360 ÷ $1,000) × 100%). Accordingly, X would have recognized revenue of $450 (36% × $1,250), which would have resulted in a margin of 20 percent.

TRG Update — Costs Related to Preproduction Activities

In November 2015, the TRG addressed certain issues related to preproduction activities. Stakeholders raised questions about how an entity should apply the new cost guidance when assessing preproduction activities, including questions related to the scope of the guidance (i.e., the costs to which such guidance would apply).

TRG members in the United States discussed whether entities should continue to account for certain preproduction costs under ASC 340-10. In addition, TRG members in the United States discussed whether preproduction costs for contracts previously within the scope of ASC 605-35 will be within the scope of ASC 340-10 or ASC 340-40 and noted that after the new revenue standard becomes effective, preproduction activities related to contracts currently within the scope of ASC 605-35 should be accounted for in accordance with ASC 340-40.

Construction Ahead — Technical Corrections

At its meeting on January 20, 2016, as a result of the TRG discussions detailed above, the FASB discussed certain technical corrections to the new revenue guidance and tentatively agreed to remove the guidance in ASC 340-10 on accounting for preproduction costs related to long-term supply arrangements. Instead of accounting for such costs in accordance with ASC 340-10, entities would account for them in accordance with ASC 340-40. See Chapter 19 for additional information and stay tuned for future developments on this topic, including whether the FASB finalizes its proposals or makes additional or modified changes to them before issuing a final ASU.

12.4 Amortization and Impairment of Contract Costs

12.4.1 Amortization

ASC 340-40

35-1 An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 340-40-25-5(a)).

ASC 340-40 does not provide specific guidance on the method an entity should use to amortize contract costs recognized as assets. Entities will therefore have to determine an appropriate method for amortizing costs capitalized in accordance with ASC 340-40-25-1 or ASC 340-40-25-5. Consider the Q&As below.

Q&A 12-8 Amortization of Capitalized Costs

Costs associated with a contract with a customer may be capitalized in accordance with ASC 340-40-25-1 or ASC 340-40-25-5; however, ASC 340-40 does not provide specific guidance on the method an entity should use to amortize these assets. Rather, ASC 340-40-35-1 states that capitalized costs should be amortized "on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates."

Question

What method should entities use to amortize costs that are capitalized in accordance with ASC 340-40-25-1 or ASC 340-40-25-5?

Answer

Amortization of capitalized costs on a "systematic basis" should take into account the expected timing of transfer of the goods and services related to the asset, which typically corresponds to the period and pattern in which revenue will be recognized in the financial statements. The pattern in which the related revenue is recognized could be significantly front-loaded, back-loaded, or seasonal, and costs should be amortized accordingly.

To determine the pattern of transfer, entities may need to analyze the specific terms of each arrangement. In determining the appropriate amortization method, they should consider all relevant factors, including (1) their experience with, and ability to reasonably estimate, the pattern of transfer and (2) the timing of the transfer of control of the goods or services to the customer. In some situations, more than one amortization method may be acceptable if it reasonably approximates the expected period and pattern of transfer of goods and services. However, certain amortization methods may be unacceptable if they are not expected to reflect the period and pattern of such transfer. When entities select a method, they should apply it consistently to similar contracts. If there is no evidence to suggest that a specific pattern of transfer can be expected, a straight-line amortization method may be appropriate.

If the pattern in which the contractual goods or services are transferred over the contract term varies significantly each period, it may be appropriate to use an amortization model that more closely aligns with the transfer pattern's variations. For example, amortization could be allocated to the periods on the basis of the proportion of the total goods or services that are transferred each period. If the cost is related to goods or services that are transferred at a point in time, the amortized cost would be recognized at the same point in time.

When the contractual goods or services are transferred over a period of uncertain duration, entities should consider whether the relationship with the customer is expected to extend beyond the initial term of a "specific anticipated contract" (as referred to in ASC 340-40-35-1 and described in ASC 340-40-25-5(a)). For example, if an entity enters into a four-year contract with a customer but the customer relationship is expected to continue for six years, the appropriate amortization period may be six years (i.e., the expected duration of the relationship).

When an entity's customer has been granted a material right to acquire future goods or services and revenue related to the material right is being deferred, it would typically be reasonable for the entity to consider the amount allocated to that right when determining the amortization method for the costs that are capitalized in accordance with ASC 340-40-25-1 or ASC 340-40-25-5.

Q&A 12-9 Amortization of Incremental Costs of Obtaining a Contract — Allocation Between Performance Obligations

ASC 340-40-25-1 and ASC 340-40-35-1 require entities to (1) capitalize as an asset the incremental costs of obtaining a contract with a customer if those costs are expected to be recovered and (2) amortize that asset "on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates" (see Q&A 12-8 for guidance on the selection of an appropriate method of amortization).

Question

Can incremental costs of obtaining a contract that are capitalized in accordance with ASC 340-40-25-1 be allocated to specific performance obligations for amortization purposes?

Answer

Yes. When an asset is recognized for the incremental costs of obtaining a contract, ASC 340-40-35-1 requires that asset to be amortized in a manner that is "consistent with the transfer to the customer of the **goods or services to which the asset relates**" (emphasis added). When the pattern of transfer differs for separate performance obligations in a contract, it may be appropriate to allocate the costs among the performance obligations, and to amortize the capitalized costs accordingly, if there is objective evidence to support the allocation.

See Q&A 12-10 for an illustration of an allocation of the costs of obtaining a contract among different performance obligations.

Note that as discussed in Q&A 12-2, an entity is not permitted to apply the practical expedient in ASC 340-40-25-4 (recognizing the "costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less") to some performance obligations in a contract but not others. Therefore, when the costs of obtaining a contract are allocated to different performance obligations such that they are amortized over different periods, the practical expedient in ASC 340-40-25-4 can only be applied if **all** of the amortization periods are one year or less.

Q&A 12-10 Amortization of Incremental Costs of Obtaining a Contract — Allocation Among Performance Obligations — Example

Entity B enters into a contract with a customer to provide the following:

- Product X delivered at a point in time.
- Maintenance of Product X for one year.
- An extended warranty on Product X that covers years 2 and 3 (Product X comes with a one-year statutory warranty).

Each of the elements is determined to be a separate performance obligation.

A sales commission of $200 is earned by the salesperson. This represents $120 for the sale of Product X (payable irrespective of whether the customer purchases the maintenance or extended warranty) and an additional $40 each for the sale of the maintenance contract and the sale of the extended warranty ($80 commission for the sale of both).

The commission is determined to meet the definition of an incremental cost of obtaining the contract in ASC 340-40-25-2 and it is therefore capitalized in accordance with ASC 340-40-25-1.

As discussed in Q&A 12-9, incremental costs of obtaining a contract that are capitalized in accordance with ASC 340-40-25-1 can be allocated to specific performance obligations for amortization purposes if there is objective evidence to support the allocation. Therefore, it would seem appropriate in the circumstances under consideration to attribute the $200 commission asset in the following manner:

- *$120 to Product X* — To be expensed upon delivery of Product X to the customer.
- *$40 to the maintenance contract* — To be expensed over the one-year period of maintenance.
- *$40 to the extended warranty* — To be expensed over the two-year period of the warranty (i.e., years 2 and 3).

The asset will therefore be amortized as follows:

	Delivery (Day 1)	Year 1	Year 2	Year 3
Product X	$ 120			
Maintenance	—	$ 40		
Extended warranty	—	—	$ 20	$ 20
Total amortization expense	$ 120	$ 40	$ 20	$ 20

Note that in this fact pattern, the entity cannot apply the practical expedient in ASC 340-40-25-4 to expense the sales commission when incurred because the total amortization period for the asset exceeds one year. Neither can the expedient be applied specifically to the commission allocated to the maintenance contract (notwithstanding that it is amortized over a period of one year) because if the practical expedient is applied, it must be applied to the contract as a whole (see Q&A 12-2).

Driving Discussion — Amortization of Costs of Obtaining a Contract

Stakeholders have also raised questions about the appropriate amortization period for a commission paid to an employee for obtaining an initial contract that has a high likelihood of renewal. That is, should the commission be amortized over the initial contract term, or should the amortization period include the expected renewal period?

For example, suppose that an entity enters into a two-year contract with a customer. On signing the initial contract, the entity pays its salesperson $200 for obtaining the contract. An additional commission of $120 is paid each time the customer renews the contract for another two years. Assume that the $120 renewal commission is not commensurate with the $200 initial commission (i.e., a portion of the $200 initial commission is related to future anticipated contract renewals and is deemed not to be commensurate with the $120 commission on the basis of the facts and circumstances evaluated in the entity's analysis), which means that some of the commission paid for the initial contract should be attributed to the contract renewal as well. On the basis of historical experience, 98 percent of the entity's customers are expected to renew their contract for at least two more years (i.e., the contract renewal is a specific anticipated contract), and the average customer life is four years.

In this example, we believe that there are at least two acceptable views on how to amortize the initial $200 commission and the $120 renewal commission:

- *View 1* — Amortize the initial commission amount of $200 over the contract period that includes the anticipated renewal (i.e., four years). When the contract is renewed, the additional $120 commission would be combined with the remaining asset and amortized over the remaining two-year period, as shown in the following table:

	Initial Contract		Renewal Contract		
	Year 1	Year 2	Year 3	Year 4	
Initial commission	$ 50	$ 50	$ 50	$ 50	$ 200
Renewal commission			60	60	120
Total expense recognized	$ 50	$ 50	$ 110	$ 110	$ 320

- *View 2* — Bifurcate the initial commission into two parts: (1) $120, the amount that is commensurate with the renewal commission and that pertains to obtaining a two-year contract, and (2) $80, the amount that is considered to be paid for obtaining the initial contract plus the anticipated renewal (i.e., the customer relationship). The $120 would then be amortized over the initial two-year contract term, and the $80 would be amortized over the entire four-year period, as shown in the following table:

	Initial Contract		Renewal Contract		
	Year 1	Year 2	Year 3	Year 4	
Initial commission — Part 1 ($120)	$ 60	$ 60			$ 120
Initial commission — Part 2 ($80 remainder)	20	20	$ 20	$ 20	80
Renewal commission			60	60	120
Total expense recognized	$ 80	$ 80	$ 80	$ 80	$ 320

12.4.2 Impairment

ASC 340-40

35-2 An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

35-3 An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 exceeds:

a. The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates, less
b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraph 340-40-25-7).

35-4 For the purposes of applying paragraph 340-40-35-3 to determine the amount of consideration that an entity expects to receive, an entity shall use the principles for determining the transaction price (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk.

35-5 Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic (for example, Topic 330 on inventory; Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed; Topic 360 on property, plant, and equipment; and Topic 350 on goodwill and other intangibles). After applying the impairment test in paragraph 340-40-35-3, an entity shall include the resulting carrying amount of the asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in Topics 360 and 350 to that asset group or reporting unit.

35-6 An entity shall not recognize a reversal of an impairment loss previously recognized.

The objective of impairment is to determine whether the carrying amount of the contract acquisition and fulfillment costs asset is recoverable. This is consistent with other impairment methods under U.S. GAAP and IFRSs that include an assessment of customer credit risk and expectations of whether variable consideration will be received.

Further, the FASB decided that it would not be appropriate to reverse an impairment charge when the reasons for impairment are no longer present. In contrast, the IASB decided to allow a reversal of the impairment charge in these circumstances. The boards decided to diverge on this matter to maintain consistency with their respective existing impairment models for other types of assets.

TRG Update — Impairment Testing of Capitalized Contract Costs

To test contract assets for impairment, an entity must consider the total period over which it expects to receive an economic benefit from the contract asset. Accordingly, to estimate the amount of remaining consideration that it expects to receive, the entity would also need to consider goods or services under a specific anticipated contract (i.e., including renewals). However, the impairment guidance appears to contradict itself because it also indicates that an entity should apply the principles used to determine the transaction price when calculating the "amount of consideration that [the] entity expects to receive."[2] The determination of the transaction price would exclude renewals.[3]

[2] ASC 340-40-35-4 (paragraph 102 of IFRS 15).
[3] ASC 606-10-32-4 (paragraph 49 of IFRS 15) states, "For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified."

At the July 2014 TRG meeting, TRG members generally agreed that when testing a contract asset for impairment, an entity would consider the economic benefits from anticipated contract extensions or renewals if the asset is related to the goods and services that would be transferred during those extension or renewal periods.

Construction Ahead — Technical Corrections to ASC 340-40

As a result of the TRG discussions noted above, the FASB discussed certain technical corrections to the new revenue guidance at its meeting on January 20, 2016, and tentatively agreed to amend ASC 340-40 to clarify that for impairment testing, an entity should:

- Consider contract renewals and extensions when measuring the remaining amount of consideration the entity expects to receive.
- Include in the amount of consideration the entity expects to receive both (1) the amount of cash expected to be received and (2) the amount of cash already received but not yet recognized as revenue.
- Test for and recognize impairment in the following order: (1) assets outside the scope of ASC 340-40 (such as inventory under ASC 330), (2) assets accounted for under ASC 340-40, and (3) reporting units and asset groups under ASC 350 and ASC 360.

See Chapter 19 for additional information, and stay tuned for future developments on this topic (including whether the FASB finalizes its proposals or makes additional or modified changes to them before issuing a final ASU).

12.5 Onerous Performance Obligations

Both U.S. GAAP and IFRSs include guidance on accounting for certain types of onerous contracts. A contract is considered onerous if the aggregate cost required to fulfill the contract is greater than the expected economic benefit to be obtained from the contract. When these conditions occur, the guidance may require an entity to recognize that expected future loss before actually incurring the loss. Onerous contracts are currently accounted for as follows:

- *U.S. GAAP* — Current guidance under U.S. GAAP addresses the recognition of losses in many specific industries and transactions, including:
  - Separately priced extended warranty and product maintenance contracts (ASC 605-20).
  - Construction- and production-type contracts (ASC 605-35).
  - Certain software arrangements (ASC 985-605).
  - Certain insurance contracts (ASC 944-605).
  - Certain federal government contracts (ASC 912-20).
  - Continuing care retirement community contracts (ASC 954-440).
  - Prepaid health care services (ASC 954-450).
  - Certain long-term power sales contracts (ASC 980-350).

  In addition, ASC 450-20 provides overall guidance on accounting for loss contingencies. Such guidance requires an entity to recognize an expected loss if the contingency is probable and the amount is reliably estimable.
- *IFRSs* — IAS 37 provides general guidance on the recognition and measurement of losses related to onerous contracts.

In developing the new revenue standard, the FASB and IASB considered including guidance on identifying and measuring onerous performance obligations (i.e., an "onerous test"). As stated in paragraph BC294 of ASU 2014-09, the boards initially (1) felt that "an onerous test was needed because the initial measurements of performance obligations are not routinely updated" and (2) "noted that including an onerous test would achieve greater convergence of U.S. GAAP and IFRS[s]."

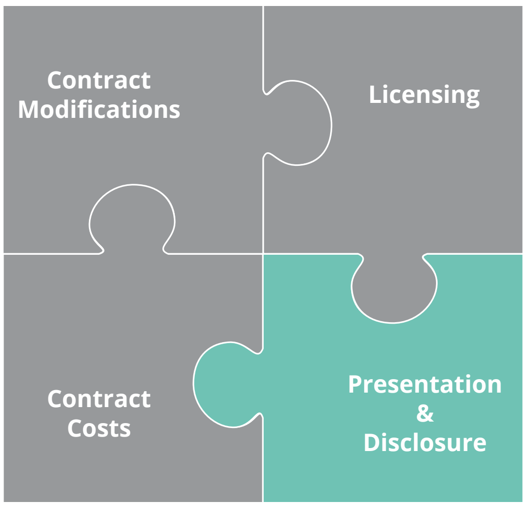
Many stakeholders disagreed with including an onerous test in the new revenue standard. Those stakeholders provided feedback indicating that application of the onerous test at the performance obligation level may result in the recognition of a liability for an onerous performance obligation even if the overall contract is expected to be profitable. In addition, stakeholders felt that the current guidance on accounting for onerous contracts was sufficient and that additional guidance was unnecessary.

The boards considered this feedback and ultimately agreed that the existing guidance under both U.S. GAAP and IFRSs sufficiently addresses onerous contracts. Consequently, the boards decided not to include specific guidance on accounting for onerous contracts in the new revenue standard.

Thinking It Through

As noted above, one of the reasons that the boards initially wanted to include an onerous test in the new revenue standard was to promote convergence between U.S. GAAP and IFRSs. Although achieving convergence was one of the goals of the new revenue standard, paragraph BC296 of ASU 2014-09 states the boards "noted that although their existing guidance on onerous contracts is not identical, they are not aware of any pressing practice issues resulting from the application of that existing guidance." Accordingly, the absence of an onerous test in the new revenue standard is not expected to hinder overall convergence of revenue recognition under U.S. GAAP and IFRSs; however, differences in the accounting for onerous contracts will remain. While the current guidance on accounting for onerous contracts has not changed, there have been changes to other guidance on recognizing revenue and costs as a result of the new revenue standard. Therefore, entities should carefully consider the interaction between the new revenue standard and existing guidance on onerous contracts to ensure that no changes result.

Chapter 13 — Presentation



13.1 Overview

ASC 606-10

45-1 When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

As discussed in Chapter 4, a contract with a customer creates legal rights and obligations. The rights under the contract will generally give rise to contract assets as the entity performs (or accounts receivable, if an unconditional right to consideration exists); and contract liabilities are created when consideration is received in advance of performance. Each reporting period, an entity is required to assess its financial position related to its contracts with customers. Depending on the extent to which an entity has performed and the amount of consideration received (or receivable) by the entity under a contract, the entity could record a contract asset or a contract liability.

Paragraph BC317 of ASU 2014-09 indicates that an entity should present its rights and obligations under a contract on a net basis. The reasoning behind this is that neither party to the contract would continue to fulfill its obligations if it knew that the other party would not perform. Because the rights and obligations in a contract are interdependent, contract assets and contract liabilities that arise in the same contract should be presented net.

Receivables should be recorded separately from contract assets since only the passage of time is required before consideration is due. That is, receivables are only subject to credit risk. In contrast, contract assets are subject to more than just credit risk (i.e., they are also subject to performance risk). As discussed in paragraph BC323 of ASU 2014-09, the FASB and IASB believed that making a distinction between contract assets and receivables was important to financial statement users. Consequently, only contract assets and contract liabilities are reported net. Accounts receivable should be reported separately.

ASC 606-10-45-5 addresses the use of alternative descriptions for contract assets and contract liabilities as follows:

ASC 606-10

45-5 This guidance uses the terms *contract asset* and *contract liability* but does not prohibit an entity from using alternative descriptions in the statement of financial position for those items. If an entity uses an alternative description for a contract asset, the entity shall provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

Paragraph BC321 of ASU 2014-09 notes the FASB's and IASB's observation that "some industries have historically used different labels to describe contract assets and contract liabilities or may recognize them in more than one line item either in the financial statements or in the notes." The ASU does not prohibit an entity from using alternative terms or from using additional line items to present the assets and liabilities, but it requires an entity to provide appropriate disclosures that adequately describe the assets and liabilities.

Terms that are commonly used in practice to describe contract assets and contract liabilities include, but are not limited to, the following:

- *Contract assets* — Unbilled receivables, progress payments to be billed.
- *Contract liabilities* — Deferred revenue, unearned revenue.

Under current U.S. GAAP, because revenue recognized for a delivered good or service is generally limited to amounts that are not contingent on future events, contract assets are recorded in limited circumstances and in limited industries. Consequently, recording contract assets may be a significant change for some entities.

13.2 Contract Liabilities

ASC 606-10

45-2 If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

A contract liability would exist when an entity has received consideration but has not transferred the related goods or services to the customer. This is commonly referred to as deferred revenue. An entity may also have an unconditional right to consideration (i.e., a receivable) before it transfers goods or services to a customer.

The example below, which is reproduced from ASC 606, illustrates how an entity would account for a contract liability and receivable. (For further discussion about receivables, see Section 13.5 below.)

ASC 606-10

Example 38 — Contract Liability and Receivable

Case A — Cancellable Contract

55-284 On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. The entity receives cash of $1,000 on March 1, 20X9 (cash is received in advance of performance).

Cash	1,000	
Contract liability		1,000

b. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	1,000	
Revenue		1,000

Case B — Noncancellable Contract

55-285 The same facts as in Case A apply to Case B except that the contract is noncancellable. The following journal entries illustrate how the entity accounts for the contract:

a. The amount of consideration is due on January 31, 20X9 (which is when the entity recognizes a receivable because it has an unconditional right to consideration).

Receivable	1,000	
Contract liability		1,000

b. The entity receives the cash on March 1, 20X9.

Cash	1,000	
Receivable		1,000

c. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	1,000	
Revenue		1,000

55-286 If the entity issued the invoice before January 31, 20X9 (the due date of the consideration), the entity would not present the receivable and the contract liability on a gross basis in the statement of financial position because the entity does not yet have a right to consideration that is unconditional.

13.3 Contract Assets

ASC 606-10

45-3 If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with Topic 310 on receivables. An impairment of a contract asset shall be measured, presented, and disclosed in accordance with Topic 310 (see also paragraph 606-10-50-4(b)).

A contract asset would exist when an entity has a contract with a customer for which revenue has been recognized (i.e., goods or services have been transferred to the customer) but customer payment is contingent on a future event (i.e., satisfaction of additional performance obligations). Such an amount is commonly referred to as an unbilled receivable.

The following example from the new revenue standard illustrates the recording of a contract asset for performance completed under a contract before an unconditional right to consideration exists:

ASC 606-10

Example 39 — Contract Asset Recognized for the Entity's Performance

55-287 On January 1, 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for $1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of $1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

55-288 The entity identifies the promises to transfer Products A and B as performance obligations and allocates $400 to the performance obligation to transfer Product A and $600 to the performance obligation to transfer Product B on the basis of their relative standalone selling prices. The entity recognizes revenue for each respective performance obligation when control of the product transfers to the customer.

55-289 The entity satisfies the performance obligation to transfer Product A.

Contract asset	400	
Revenue		400

55-290 The entity satisfies the performance obligation to transfer Product B and to recognize the unconditional right to consideration.

Receivable	1,000	
Contract asset		400
Revenue		600

13.4 Whether to Present as Current and Noncurrent

13.4.1 Contract Assets and Contract Liabilities

Q&A 13-1 Presentation of Contract Assets and Contract Liabilities in a Classified Balance Sheet

ASC 606 includes the following definitions of "contract asset" and "contract liability":

- *Contract asset* — "An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance)."
- *Contract liability* — "An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer."

A contract asset would exist when an entity has a contract with a customer for which revenue has been recognized but payment is contingent on a future event (e.g., unbilled receivables). A contract liability would exist when an entity has received consideration but has not been able to recognize the related revenue (e.g., deferred revenue).

Question

Should contract assets and contract liabilities be presented as current and noncurrent in a classified balance sheet?

Answer

Yes. In a manner similar to the treatment of assets and liabilities related to the receipt or use of cash (e.g., receivables, prepaid assets, or debt), contract assets and contract liabilities should be bifurcated between current and noncurrent when presented in a classified balance sheet. Note that the contract asset or contract liability determined at the contract level (i.e., after the contract assets and contract liabilities for each performance obligation within a single contract have been netted as discussed in Section 13.1) is the contract asset or contract liability that should be bifurcated between current and noncurrent when presented in a classified balance sheet.

See Q&A 13-2 for discussion on the presentation of recognized assets for incremental costs to obtain and fulfill a contract in a classified balance sheet. The requirement above differs for the presentation of capitalized contract costs.

13.4.2 Capitalized Contract Costs

Q&A 13-2 Presentation of Capitalized Contract Costs in a Classified Balance Sheet

ASC 340-40 requires entities to capitalize certain incremental costs of obtaining a contract with a customer and certain costs to fulfill a contract.

Question

Should costs to obtain or fulfill a contract that are capitalized under ASC 340-40 be presented as current and noncurrent in a classified balance sheet?

Answer

No. In a manner similar to the treatment of intangible assets; inventory; or property, plant, and equipment, capitalized costs to obtain or fulfill a contract under ASC 340-40 should be presented as a single asset and neither bifurcated nor reclassified between current and noncurrent assets. That is, the assets would be classified as long-term unless they had an original amortization period of one year or less.

See Q&A 13-1 for discussion on the presentation of contract assets and contract liabilities in a classified balance sheet. The requirement above differs for contract assets and contract liabilities.

13.5 Receivables

ASC 606-10

45-4 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310 {and Subtopic 326-20}. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Topic 310 {Subtopic 326-20} and the corresponding amount of revenue recognized shall be presented as an expense (for example, as an impairment loss) {as a credit loss expense}.

The new revenue standard was not intended to change either the timing of receivable recognition or the subsequent accounting for receivables. While both contract assets and receivables are similar in that they represent a customer's right to consideration for work performed, the risks associated with each differ. As noted in Section 13.1 above, receivables are only exposed to credit risk since only the passage of time is required before receivables are due. However, contract assets are exposed to both credit risk and other risks (i.e., performance risk).

An entity could have a present and unconditional right to payment, and therefore a receivable, even if there is a refund obligation that may require the entity to pay consideration to a customer in the future (e.g., when a product is returned, or when rebates are earned on a specified volume of purchases). Since refund obligations give rise to variable consideration, they could affect the transaction price (see Section 6.2.5.2) and the amount of revenue recognized. However, an entity's present right to consideration would not be affected by the potential need to refund consideration in the future. Consequently, in certain circumstances, a gross receivable could be recorded along with a contract liability. This is discussed further in paragraph BC326 of ASU 2014-09 and is illustrated in the following example from ASC 606:

ASC 606-10

Example 40 — Receivable Recognized for the Entity's Performance

55-291 An entity enters into a contract with a customer on January 1, 20X9, to transfer products to the customer for $150 per product. If the customer purchases more than 1 million products in a calendar year, the contract indicates that the price per unit is retrospectively reduced to $125 per product.

55-292 Consideration is due when control of the products transfer to the customer. Therefore, the entity has an unconditional right to consideration (that is, a receivable) for $150 per product until the retrospective price reduction applies (that is, after 1 million products are shipped).

ASC 606-10 (continued)

55-293 In determining the transaction price, the entity concludes at contract inception that the customer will meet the 1 million products threshold and therefore estimates that the transaction price is $125 per product. Consequently, upon the first shipment to the customer of 100 products the entity recognizes the following.

Receivable	15,000[a]	
Revenue		12,500[b]
Refund liability (contract liability)		2,500

(a) $150 per product × 100 products

(b) $125 transaction price per product × 100 products

55-294 The refund liability (see paragraph 606-10-32-10) represents a refund of $25 per product, which is expected to be provided to the customer for the volume-based rebate (that is, the difference between the $150 price stated in the contract that the entity has an unconditional right to receive and the $125 estimated transaction price).

TRG Update — When to Record Receivables

At the April 2016 FASB-only TRG meeting, the FASB staff noted that it has received questions about the point in time at which a receivable should be recorded under a contract with a customer (including when contract assets would be reclassified as accounts receivable). The FASB staff agreed that some confusion may result from the wording in Case B in Example 38 of the new revenue standard (reproduced in Section 13.2 above), which some believe is not aligned with the guidance that identifies a receivable as a right to consideration that is unconditional other than for the passage of time. The staff noted that it would ask the Board to consider a technical correction to clarify the wording in the example.

In addition, the staff noted that it has received other questions, including inquiries about situations in which performance occurs over time and whether receivables should be recorded as performance occurs or when amounts are invoiced and due. The staff noted that there is diversity in practice today regarding how and when receivables are recorded and that such diversity is not likely to be eliminated under the new standard. However, the staff reiterated that these questions do not affect revenue recognition; rather, they affect the presentation of assets on an entity's balance sheet.

See Chapter 19 for additional information, and stay tuned for future developments on this topic.

Q&A 13-3 Recording a Receivable for a Performance Obligation That Is Satisfied Before Payment Is Due

On March 1, 20X1, Entity A enters into a contract with one performance obligation (software license that is determined to be satisfied at a point in time) for $3,600. Entity A delivers the software license on March 1, 20X1, and will invoice the customer in three equal and annual installments of $1,200 on March 1 of 20X1, 20X2, and 20X3. Payment is due by April 1 of each year.

Question

How should the entity reflect this transaction on its balance sheet as of March 31, 20X1?

Answer

Entity A should record a receivable for the full contract amount ($3,600) when it satisfies the performance obligation on March 1, 20X1. That is, the $3,600 should be recorded as a receivable in accordance with ASC 606-10-45-4, which states that a "receivable is an entity's right to consideration that is unconditional" and a "right to consideration is unconditional if only the passage of time is required before payment of that consideration is due." As noted in paragraph BC323 of ASU 2014-09, "making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. That is because although both would be subject to credit risk, a contract asset also is subject to other risks, for example, performance risk." In this scenario, A's rights are only subject to credit risk.

Driving Discussion — Presentation of Contract Assets, Contract Liabilities, and Receivables

At the April 2016 FASB-only TRG meeting, the FASB staff acknowledged potential diversity in practice related to when receivables are recorded in multiperiod contracts that include performance obligations satisfied over time. Consider the following example:

Example 13-1

On March 1, 20X1, Entity A enters into two identical (other than payment terms) noncancelable contracts with two different customers, Customer Y and Customer Z. The contracts each contain the same single performance obligation (i.e., cleaning services) that is satisfied over time. The transaction price is $2,400. Each customer is issued an invoice on March 1, 20X1, and A provides continuous service from March 1, 20X1, through February 28, 20X2. Customer Y's payment is due on March 31, 20X1, but is received by A on April 15, 20X1. Customer Z's payment is due on April 15, 20X1. There are multiple views on how A should reflect these transactions on its balance sheet as of March 31, 20X1:

- *View A* — Entity A should record a receivable when it issues an invoice to its customer **and** begins satisfying the performance obligation. The right to consideration is unconditional because only the passage of time up to the due date is required (since A has already begun performing the services). Accordingly, A's transactions with Y and Z would be reflected in the financial statements as follows:

Customer Y		
Receivable	2,400	
Contract liability		2,200
Revenue		200
Customer Z		
Receivable	2,400	
Contract liability		2,200
Revenue		200

Example 13-1 (continued)

- *View B* — Until the invoice is due, A should build up its receivable balance incrementally as it satisfies its performance obligation. For Y, since payment is due on March 31, 20X1, the full receivable balance is recorded. For Z, the full receivable balance would be recorded once payment is due on April 15, 20X1. Accordingly, A's transactions with Y and Z would be reflected in the financial statements as follows:

Customer Y

Receivable	2,400	
Contract liability		2,200
Revenue		200

Customer Z

Receivable	200	
Contract asset	2,200*	
Contract liability		2,200*
Revenue		200

* Contract asset and contract liability would be netted on the face of the balance sheet.

Discussions with the FASB staff confirmed that the Board did not intend to change practice related to when receivable balances are recorded. Depending on an entity's existing accounting policies, either View A or View B could be acceptable.

Driving Discussion — Allocation of Cash Payments to Performance

At the October 2014 TRG meeting, TRG members generally agreed that contract assets and contract liabilities should be determined at the contract level (i.e., not at the performance obligation level) and that only a net contract asset or net contract liability should be presented for a particular contract. Receivables, however, would be presented separately from contract assets and contract liabilities. See Q&A 13-4.

At the March 2015 TRG Meeting, TRG members discussed the difficulty of determining when a customer paid for a particular good or service under a contract involving multiple promised goods or services because of the fungible nature of cash (see Section 7.6 for additional discussion about allocating cash payments to specific performance obligations). Since receivables are presented separately from contract assets and contract liabilities, the allocation of cash to performance obligations in a contract involving multiple performance obligations could also affect the recognition of receivables, contract assets, and contract liabilities. Consider the following example:

Example 13-2

On January 1, 20X1, Entity A enters into a noncancelable contract with a customer that contains two performance obligations: a software license (satisfied at a point in time) and a service (satisfied over time from January 1, 20X1, through December 31, 20X3). Entity A issues an invoice on January 1, 20X1, for the first year (due on February 1, 20X1) and subsequently issues an invoice on each anniversary for the next two years. The transaction price of the contract is $6,000 (invoiced at $2,000 per year). As a result of allocating the transaction price to each performance obligation on a relative stand-alone selling price basis, 60 percent of revenue ($3,600) is allocated to the license and 40 percent of revenue ($2,400) is allocated to the service. Contractually, each $2,000 invoice provides the right to receive service for one year ($800) and applies to one-third of the total license fee of $3,600. Entity A has the contractual right to bill and collect payment for the remaining license fee independent of providing any future service.

On January 1, 20X1, the software license is transferred to the customer and the service commences. The customer pays the $2,000 invoice in full on February 1, 20X1. Entity A has an accounting policy of recording the receivable when amounts are invoiced and the associated performance obligation has been satisfied or has commenced.

Stakeholders have expressed the following views on how this transaction should be presented as of and for the period ended March 31, 20X1:

- *View A* — To identify the receivable amount in this contract, A must first allocate the payment made on February 1, 20X1, to the performance obligations contractually tied to the payment. Entity A would then determine the remaining receivable for performance obligations satisfied when payment is unconditional. Accordingly, the transaction would be reflected in the financial statements as follows:

License:		
Cash (60% × $2,000)	1,200	
Receivable (unbilled)	2,400*	
Revenue		3,600
Service:		
Cash (40% × $2,000)	800	
Contract asset**	1,600***	
Contract liability** [($2,400 ÷ 36) × 33]		2,200
Revenue [($2,400 ÷ 36) × 3]		200
Consolidated:		
Cash	2,000	
Receivable (unbilled)	2,400	
Contract asset**	1,600	
Contract liability**		2,200
Revenue		3,800

* The $2,400 represents the entity's unconditional right to payment in years 2 and 3.

** Contract asset and contract liability would be netted, and net contract liability of $600 related to services paid in advance would be recorded.

*** The $1,600 represents the entity's right to payment in years 2 and 3 that is conditional on providing future services.

Example 13-2 (continued)

- *View B* — Entity A would allocate cash entirely to the satisfied performance obligations (i.e., the software license and the satisfied portion of the service) and record the remaining consideration due that is associated with the satisfied performance obligations as an unbilled receivable. Consequently, as illustrated below, A would not present any contract liability for services paid for by the customer before performance.

Cash	2,000	
Receivable (unbilled)*	1,800	
Contract asset** [($2,400 ÷ 36) × 33]	2,200	
Contract liability** [($2,400 ÷ 36) × 33]		2,200
Revenue ($3,600 + [($2,400 ÷ 36) × 3])		3,800

* Since revenue related to fulfilling the service obligation is recognized under View B, the entity would also record a receivable (unbilled) throughout the year before issuing an invoice. In year 3, the entity would present a net contract liability since payment would have been received in advance for year 3 services.

** Contract asset and contract liability would be netted to $0.

Because cash is fungible and can be allocated at either the contract level or the performance obligation level, either View A or View B could be acceptable. Entities should apply a consistent approach for similar contracts and in similar circumstances.

13.6 Other Presentation Matters

13.6.1 Unit of Account for Presentation

Q&A 13-4 Presentation of a Contract as a Single Contract Asset or Contract Liability

Under ASC 606, a "contract asset" can arise when the amount of revenue recognized by an entity **exceeds** the amount that has already been paid by the customer together with any unpaid amounts recognized as receivables. Conversely, a "contract liability" can arise when the amount of revenue recognized by an entity is **less** than the amount that has already been paid by the customer together with any unpaid amounts recognized as receivables.

When there are multiple performance obligations in a contract (or in multiple contracts accounted for as a single combined contract in accordance with ASC 606-10-25-9), it is possible that revenue recognized is in excess of amounts paid or receivable for some performance obligations but less than amounts paid or receivable for other performance obligations.

Question

In such circumstances, should an entity recognize separate contract assets (for those performance obligations for which revenue exceeds amounts paid or receivable) and contract liabilities (for those performance obligations for which revenue is less than amounts paid or receivable)?

Answer

No. The appropriate unit of account for presenting contract assets and contract liabilities is the contract. Accordingly, it is not appropriate to present both contract assets and contract liabilities for a single contract; instead, a single net figure should be presented.

ASC 606-10-45-1 states that "[w]hen either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable."

This also applies to circumstances in which multiple contracts are combined and are accounted for as a single contract in accordance with the requirements for combination in ASC 606-10-25-9.

Paragraph BC317 of ASU 2014-09 explains that "[t]he boards decided that the remaining rights and performance obligations **in a contract** should be accounted for and **presented on a net basis**, as either a contract asset or a contract liability. . . . The Boards decided that those interdependencies are best reflected by **accounting and presenting** on a net basis the remaining rights and obligations in the statement of financial position" (emphasis added).

See also Q&A 13-5 on the subject of offsetting contract assets and contract liabilities against other assets and liabilities.

The TRG discussed this issue in October 2014; a summary of the TRG's discussion is available in TRG Agenda Paper 11. For additional information and Deloitte's summary, see Appendixes D and E.

13.6.2 Balance Sheet Offsetting

Q&A 13-5 Offsetting Contract Assets and Contract Liabilities Against Other Assets and Liabilities

ASC 606 introduces the terms "contract asset" and "contract liability" (defined in ASC 606-10-20) in the context of revenue arising from contracts with customers and provides guidance on the presentation of contract assets and contract liabilities in the statement of financial position (see ASC 606-10-45-1 through 45-5). Entities may also recognize other types of assets or liabilities as a result of revenue or other transactions related to customers. Examples might include costs of obtaining a contract capitalized in accordance with ASC 340-40-25-1, financial assets or liabilities as defined in ASC 825-10-20, and provisions as defined in ASC 460.

Question

May an entity offset other assets and liabilities against contract assets and contract liabilities?

Answer

In practice, it will not be possible for entities to offset other assets and liabilities against contract assets and contract liabilities. ASC 210-20 prohibits offsetting of assets and liabilities unless required or permitted by another Codification subtopic, and neither ASC 606-10 nor any other Codification subtopic includes such a requirement or permission with respect to contract assets and contract liabilities.

The TRG discussed this issue in October 2014, with general agreement that entities should refer to other Codification subtopics when determining whether to offset other assets or liabilities against the contract asset or contract liability. A summary of the TRG's discussion is available in TRG Agenda Paper 11. For additional information and Deloitte's summary, see Appendixes D and E.

13.6.3 Income Statement Classification of Interest

Q&A 13-6 Classification of Interest Income Generated by a Financing Subsidiary in Consolidated Financial Statements

Many companies offer financing arrangements to customers who purchase their products. Some of these companies may also offer financing of products sold by other vendors. Often, the financing is offered through a wholly owned subsidiary of the parent company. In other situations, the parent itself may also offer this financing.

Question

For purposes of the consolidated financial statements, how should the interest income generated from these financing arrangements be classified in the income statement?

Answer

In these situations, the interest income may be classified as revenue. Paragraph BC29 of ASU 2014-09 states that the FASB and IASB "decided not to amend the existing definitions of revenue in each of their conceptual frameworks." Therefore, entities should continue to apply the guidance in paragraph 79 of FASB Concepts Statement 6 which indicates that cash inflows, such as interest, that are the **result of an entity's ongoing major or central operations** represent revenue. When the major activity of a subsidiary is the financing of products, the interest income generated from this financing would represent its major revenue-generating activity. Therefore, this interest income would continue to be classified as revenue for consolidated financial statement purposes. However, the interest income (i.e., the financing component) should be presented separately from the revenue from the sale (i.e., revenue from contracts with customers) in accordance with the requirements of ASC 606-10-32-20.

Conversely, if interest income is generated as a result of an activity that does not derive from an entity's ongoing major or central operations (i.e., an activity that is peripheral or incidental to an entity's central activities, as described by paragraph 75 of Concepts Statement 6), such income is unlikely to be classified as revenue.

SEC registrants' analysis of whether the activity generating the interest income is a result of the ongoing major or central operations should include questions such as the following:

- Does management discuss the financing operation in the MD&A or Business sections of the Form 10-K?
- Does management provide focus on the financing operation in other external communications (e.g., analyst calls, press releases)?
- Is the financing operation a separate reportable segment?

SEC registrants should also consider the guidance in SEC Regulation S-X, Rule 5-03, regarding separate disclosure of revenue from services and revenue from products when presenting this interest income in the statement of comprehensive income.

The following examples demonstrate the concepts explained above.

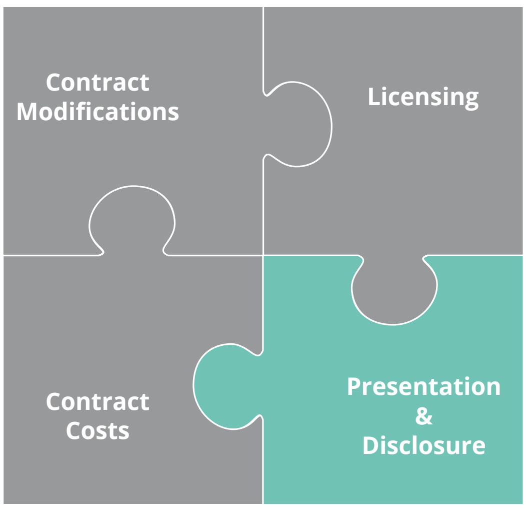
Example 1

Company A sells machinery. The company has a subsidiary, B, whose sole operations are to provide financing to customers who purchase the machinery from A. In this situation, the interest income generated by B from its product financing is part of the consolidated entity's major ongoing operations and should therefore be classified as revenue in A's consolidated statement of comprehensive income, separately from revenue from contracts with customers.

Example 2

Company X sells vehicles. The company does not have a financing subsidiary, has not previously provided financing to its customers, and does not have any intent to provide financing in the future. However, as a result of a large order placed by Customer Y, X has agreed to provide financing to Y. In this situation, because X has no history of providing financing to customers, and because financing arrangements are not part of X's ongoing operations, the interest income generated from Y should not be classified as revenue in X's consolidated financial statements.

Chapter 14 — Disclosure



14.1 Background and Objective

As discussed in paragraph BC327 of ASU 2014-09, some of the main criticisms of the prior revenue guidance from regulators and users of the financial statements were related to disclosure requirements. Many entities' disclosures contained boilerplate language that, broadly speaking, regulators and users found to be inadequate and lacking in cohesion with other disclosures; this made it hard for users to understand entities' revenues, judgments related to revenue, and how revenue is related to an entity's overall financial position. In addition, whereas disclosure had been a focus of the FASB and SEC in recent years — mainly, expanded disclosure related to topics such as pensions, stock compensation, fair value, and income taxes — there was a lack of disclosure about revenue, which was highlighted as a key area for improvement during the development of the new revenue standard.

As a result, one of the goals of the FASB and IASB in the revenue project was to provide financial statement users with more useful information through improved disclosures. ASC 606-10-50-1 outlines the objective of the new revenue standard's disclosure requirements as follows:

ASC 606-10

50-1 The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

a. **Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)**
b. **The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)**
c. **Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).**

Thinking It Through — System and Implementation Challenges

As discussed in Section 1.8.2, the new revenue standard requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The new revenue standard's disclosure requirements are significantly more comprehensive than those in existing revenue standards. Entities should be proactive in developing the disclosures required by the new standard because of the substantive system and implementation challenges that may arise when entities (1) gather the information necessary for drafting the required disclosures and (2) implement controls to review related disclosures and underlying data. Among the disclosures that may pose system and implementation challenges are those related to (1) remaining performance obligations (commonly referred to as the "backlog" disclosure), (2) contract assets and contract liabilities, and (3) disaggregation of revenue (including the relationship between disaggregated revenue and segment information). Even if the timing or amount of revenue recognized is not affected by the new revenue standard, the disclosure obligations will be affected.

To achieve their goal of improving existing revenue disclosures, the boards introduced new and expanded disclosure requirements, which are both quantitative and qualitative as well as significantly more comprehensive than current guidance. Meeting these disclosure requirements will require significant judgment. Some disclosures may be applicable for some entities while immaterial or extraneous for others.

14.1.1 Level of Aggregation or Disaggregation

ASC 606-10

50-2 An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

Entities should (1) "consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements,"[1] (2) "aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics,"[2] and (3) not repeat disclosures if the information is already presented in the manner required by other accounting standards.

14.1.2 Disclosures in Comparative Periods

ASC 606-10

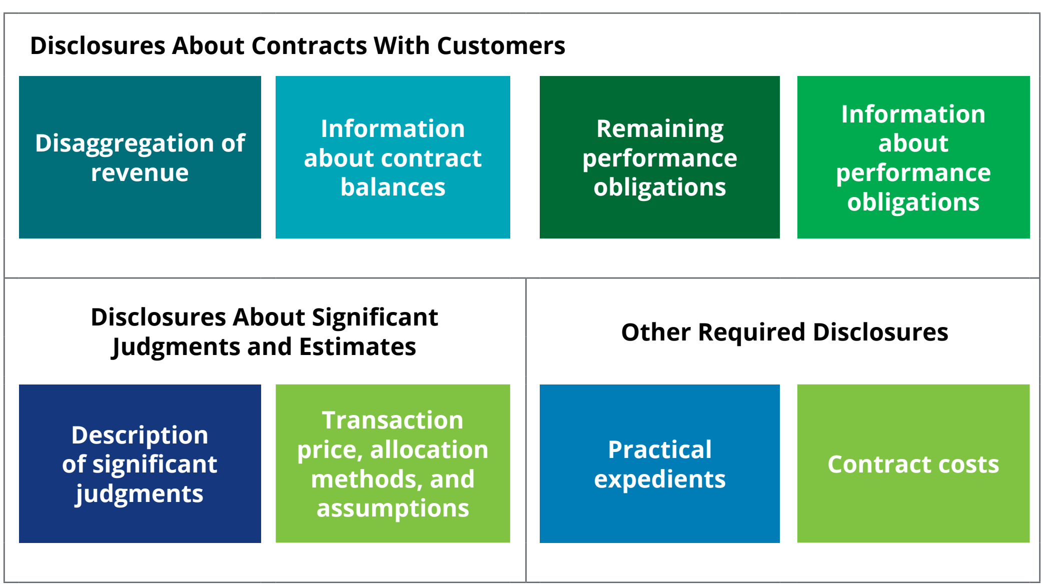
50-3 Amounts disclosed are for each reporting period for which a statement of comprehensive income (statement of activities) is presented and as of each reporting period for which a statement of financial position is presented. An entity need not disclose information in accordance with the guidance in this Topic if it has provided the information in accordance with another Topic.

In a manner consistent with presentation requirements, entities are required to provide the prescribed disclosures for both current and comparative periods. See also Q&A 15-3 for a discussion of the disclosures that are required when an entity elects to use the modified retrospective approach for adoption.

Throughout this chapter of the Roadmap, we will provide examples that illustrate certain portions of the new disclosure guidance. Illustrative examples are included to raise questions and provide direction; however, they are not intended to be templates or comprehensive resources. Guidance and examples should be used as tools to solicit and encourage discussion about key judgments and potential questions arising in the application of the requirements.

The illustration below gives an overview of the annual disclosure requirements in ASC 606 (there are certain exceptions for nonpublic entities; see Chapter 16).

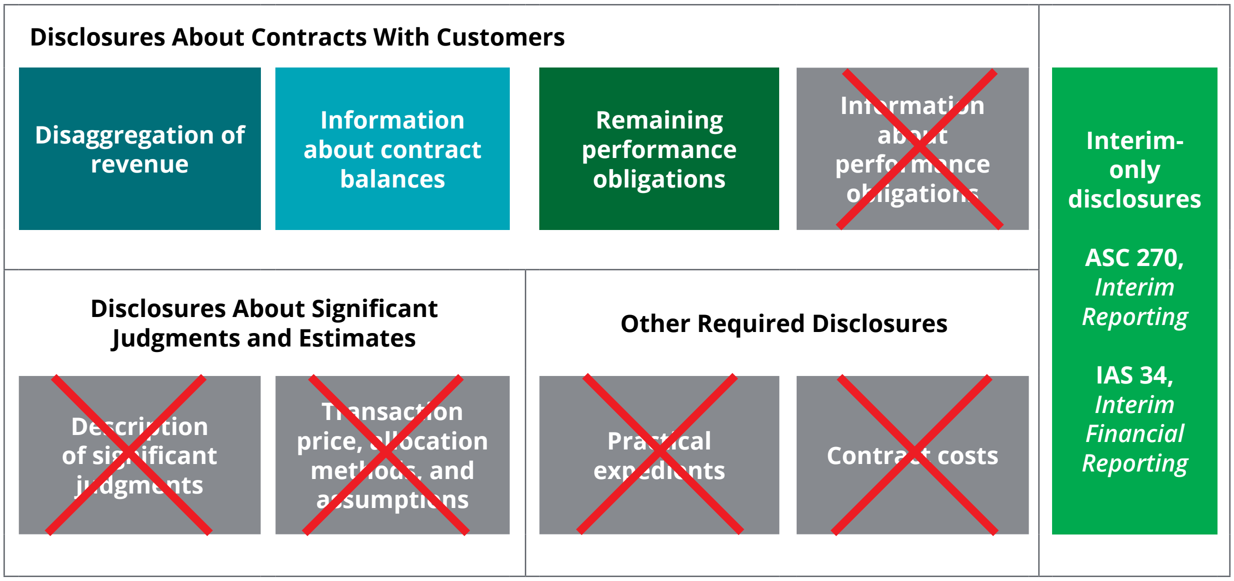
Annual Disclosures



[1] Quoted from ASC 606-10-50-2.
[2] See footnote 1.

The illustration below gives an overview of the interim disclosure requirements in ASC 270. The items shown in gray illustrate the annual required disclosures that are not required during interim periods.

Interim Disclosures[3]



Refer to Section 14.6 for a more comprehensive summary of the disclosure requirements, including information on practical expedients for nonpublic entities as well as interim disclosures.

Q&A 14-1 Omission of Disclosures

ASC 606-10-50-1 notes that the "objective of the disclosure requirements in [ASC 606] is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The revenue standard delineates three broad disclosure categories and detailed disclosure requirements for meeting this objective.

Question

When would an entity be permitted to exclude from its financial statements a specific disclosure that is otherwise required under ASC 606?

Answer

Throughout ASC 606-10-50, the FASB consistently uses the term "shall" in conjunction with the information specified (e.g., "shall disclose," "shall provide," "shall explain"). Therefore, the specific disclosures would generally be required. However, like other mandatory disclosure provisions in the Codification, those in ASC 606 do not require financial statement disclosures

[3] IAS 34 provides the interim disclosure requirements under IFRSs. In addition, IFRS 15 amended IAS 34 to require entities to disclose information about disaggregated revenue from contracts with customers during interim periods. IFRS 15 does not require entities to disclose information about contract balances and remaining performance obligations on an interim basis as required under U.S. GAAP. For further information, see the table of differences between U.S. GAAP and IFRSs in Appendix A.

that are irrelevant or immaterial. In paragraph BC331 of ASU 2014-09, the FASB and IASB acknowledge that an entity needs to consider both relevance and materiality when determining the disclosures to be provided:

> The [FASB and IASB] also decided to include disclosure guidance to help an entity meet the disclosure objective. However, those disclosures should not be viewed as a checklist of minimum disclosures, because some disclosures may be relevant for some entities or industries but may be irrelevant for others. The Boards also observed that it is important for an entity to consider the disclosures together with the disclosure objective and materiality. Consequently, [ASC] 606-10-50-2 clarifies that an entity need not disclose information that is immaterial.

For example, an entity would most likely not discuss the methods it uses to measure progress on performance obligations satisfied over time if (1) revenue was not recognized in such a manner or (2) management concludes that the quantitative and qualitative impact of the disclosure requirement is immaterial (e.g., an insignificant portion of total revenue is recognized in such manner). However, as with other materiality assessments, entities should carefully consider whether the omission of a required disclosure represents an error. Entities are encouraged to consult with their legal and financial advisers when making such determinations.

Further, while the disclosures specified in ASC 606 are generally viewed as mandatory, the manner in which an entity satisfies each of the revenue standard's disclosure requirements may vary significantly. ASC 606-10-50-2 states:

> An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

Accordingly, the level of detail that an entity includes to achieve each of the specific disclosure requirements could differ depending on the entity's specific facts and circumstances.

The assessment of which disclosures need to be provided should be made for each reporting period since a disclosure deemed to be irrelevant or immaterial in previous periods may subsequently become material (e.g., as a result of increases in the monetary values to be disclosed or changes in qualitative factors).

14.2 Contracts With Customers

ASC 606-10

50-4 An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other Topics:

a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue
b. Any impairment losses recognized (in accordance with Topic 310 on receivables) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses from other contracts.
{b. Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from credit losses from other contracts.}

The first disclosure requirement seems obvious, but it may not always be straightforward. That is, an entity must disclose its revenue from contracts with customers unless the revenue is presented separately in the statement of comprehensive income (or statement of activities, in the case of a nonprofit entity). As a result, the entity must determine which of its contracts or revenue streams are being accounted for in accordance with ASC 606 rather than in accordance with guidance on other revenue transactions, such as those related to financial instruments (interest income), leases (lease income), or insurance contracts. For example, an entity may be a lessor and derive revenue from its leasing operations in addition to various services it provides in contracts with customers. As further discussed in Chapter 3, some contracts with customers (or portions of contracts with customers) are outside the scope of ASC 606. In those circumstances, unless the lessor's two sources of revenue are separately presented in the income statement, the lessor must disclose the breakdown of those two revenue sources: (1) revenue from contracts with customers (i.e., those contracts or portions of a contract that are being accounted for in accordance with ASC 606) and (2) lease income accounted for in accordance with ASC 840 (or ASC 842, upon adoption of the new leases standard).

To take another example, an entity that derived revenue from financial instruments, leases, and contracts with customers (ASC 606 contracts) may present or disclose its revenues as follows:

Revenue from contracts with customers	$ 6,000
Interest income	2,000
Lease income	3,000
Revenue	$ 11,000

Similarly, an entity is required to disclose any impairment losses related to its contracts with customers separately from other impairments, such as losses recorded on other financial instruments (e.g., investments) or lease receivables.

14.2.1 Disaggregation of Revenue

The table below summarizes the disclosure requirements discussed in this section, including practical expedients available to nonpublic entities as well as required interim disclosures.

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Disaggregation of revenue	Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors.	Yes[4]	Yes
	Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information.	Yes	Yes

[4] At a minimum, an entity must disclose revenue that is disaggregated in accordance with the timing of transfer of goods or services (e.g., goods transferred at a point in time and services transferred over time).

To meet the new revenue standard's disclosure objective, an entity is required to disaggregate revenue into categories. Revenue from contracts with customers presented in the statement of comprehensive income generally comprises sales of various types of goods and services and involves customers from different markets or geographical regions. As discussed in paragraph BC336 of ASU 2014-09, "because the most useful disaggregation of revenue depends on various entity-specific or industry-specific factors, the Boards decided that [ASC] 606 should not prescribe any specific factor to be used as the basis for disaggregating revenue from contracts with customers." Instead, the boards included implementation guidance that provides examples of categories that may be appropriate to disclose in an entity's financial statements. One or more than one category may be presented depending on what is most meaningful to the business.

The new implementation guidance also suggests that an entity should consider various sources of information (e.g., investor information, internal reports) in determining the categories to use for disaggregation of revenue. To enable users of the financial statements to understand the relationship between an entity's revenue and financial position and how the entity manages its business, entities are required to describe the relationship between disaggregated revenue and segment disclosures in accordance with ASC 280. These disclosures do not need to be in a particular format; as a result, some entities may describe the interaction between the two required disclosures in the revenue footnote, while others may include the disclosures in the segment footnote. In addition, since the guidance is not prescriptive, the disclosures may also be presented in a tabular format or narrative format.

Entities should examine whether (1) the information necessary to produce these disclosures is readily available and (2) there are proper controls in place for reviewing this information.

ASC 606-10

50-5 An entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

ASC 606-10

55-89 Paragraph 606-10-50-5 requires an entity to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 606-10-50-5 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue.

55-90 When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following:

a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)
b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments
c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

ASC 606-10 (continued)

55-91 Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)
b. Geographical region (for example, country or region)
c. Market or type of customer (for example, government and nongovernment customers)
d. Type of contract (for example, fixed-price and time-and-materials contracts)
e. Contract duration (for example, short-term and long-term contracts)
f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

ASC 606-10

50-6 In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

50-7 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission (SEC), may elect not to apply the quantitative disaggregation disclosure guidance in paragraphs 606-10-50-5 through 50-6 and 606-10-55-89 through 55-91. If an entity elects not to provide those disclosures, the entity shall disclose, at a minimum, revenue disaggregated according to the timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time) and qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

The following example in ASC 606 illustrates how an entity could present the disaggregation of its revenue in a tabular format to meet the quantitative disclosure requirements in ASC 606-10-50-6:

ASC 606-10

Example 41 — Disaggregation of Revenue — Quantitative Disclosure

55-296 An entity reports the following segments: consumer products, transportation, and energy, in accordance with Topic 280 on segment reporting. When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines, and timing of revenue recognition (that is, goods transferred at a point in time or services transferred over time).

ASC 606-10 (continued)

55-297 The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 606-10-50-5, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation, and energy segments in accordance with paragraphs 606-10-50-6.

Segments	Consumer Products	Transportation	Energy	Total
Primary Geographical Markets				
North America	$ 990	$ 2,250	$ 5,250	$ 8,490
Europe	300	750	1,000	2,050
Asia	700	260	—	960
	$ 1,990	$ 3,260	$ 6,250	$ 11,500
Major Goods/Service Lines				
Office supplies	$ 600	—	—	$ 600
Appliances	990	—	—	990
Clothing	400	—	—	400
Motorcycles	—	500	—	500
Automobiles	—	2,760	—	2,760
Solar panels	—	—	1,000	1,000
Power plant	—	—	5,250	5,250
	$ 1,990	$ 3,260	$ 6,250	$ 11,500
Timing of Revenue Recognition				
Goods transferred at a point in time	$ 1,990	$ 3,260	$ 1,000	$ 6,250
Services transferred over time	—	—	5,250	5,250
	$ 1,990	$ 3,260	$ 6,250	$ 11,500

Thinking It Through — Determining Level of Disaggregation

In recent years, segment reporting has been a perennial topic of focus for the SEC (and SEC comment letters) and, as such, a topic of focus for many companies. Focus areas related to segments include (1) the identification and aggregation of operating segments, (2) changes in reportable segments, (3) product and service revenue by segment, (4) operating segments and goodwill impairment, and (5) information about geographical areas. Because of the current challenges related to segment disclosures and the new revenue standard's requirements related to segments, it is critical for each organization to evaluate the appropriate level at which to present its disaggregated revenue balances. As stated in ASC 606-10-55-90, an entity can make this determination by using (1) "[d]isclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)," (2) "[i]nformation regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments," and (3) other similar information "that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions."

The following illustrative disclosure of a company's disaggregation of revenue highlights some of the questions an entity may think about when implementing the guidance on disaggregating revenue balances:

Illustrative Disclosure — Disaggregation of Revenue

In accordance with ASC 606-10-50, the Company disaggregates revenue from contracts with customers into geographical regions, major goods and service lines, and timing of transfer of goods and services. The Company determines that disaggregating revenue into these categories achieves the disclosure objective to depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. As noted in the segment information footnote, the Company's business consists of Segment A, Segment B, and Segment C. A reconciliation of disaggregated revenue to segment revenue as well as revenue by geographical regions is provided in Segment Note X.

Segments	Segment A	Segment B	Segment C	Total
Primary Geographical Markets				
North America	$ 10	$ 20	$ 50	$ 80
Europe	70	10	10	90
Asia	60	20	—	80
	$ 140	$ 50	$ 60	$ 250
Major Goods/Service Lines				
Major goods Category A	$ 100	$ —	$ —	$ 100
Major goods Category B	40	—	—	40
Major goods Category C	—	20	—	20
Major goods Category D	—	25	—	25
Service Line A	—	5	40	45
Service Line B	—	—	20	20
	$ 140	$ 50	$ 60	$ 250
Timing of Revenue Recognition				
Goods transferred at a point in time	$ 140	$ 45	$ —	$ 185
Services transferred over time	—	5	60	65
	$ 140	$ 50	$ 60	$ 250

Consider information in segment disclosure, MD&A, and presented in investor calls.

Is information reconciled to segment disclosures?

Should more than one category be used to disaggregate?

What entity- or industry-specific factors are most meaningful to your business?

Is this information currently available?

Where does it come from?

What controls are in place to ensure that the obtained information is accurate and complete?

14.2.2 Contract Balances

The table below summarizes the disclosure requirements discussed in this section through Section 14.2.2.4, including practical expedients available to nonpublic entities as well as required interim disclosures.

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Contract balances	Opening and closing balances (receivable, contract assets, and contract liabilities).	No	Yes
	Amount of revenue recognized from beginning contract liability balance.	Yes	Yes
	Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).	Yes	Yes
	Explanation of significant changes in contract balances (using qualitative and quantitative information).	Yes	Yes

In a manner that reflects the current lack of cohesion between revenue and other disclosures, many entities under current U.S. GAAP present working capital balances, such as deferred revenue and unbilled receivables, but do not disclose how the trends or changes associated with these balances are related to revenue. According to paragraph BC343 of ASU 2014-09:

> Users of financial statements emphasized that it was critical to them to have information on the movements in the contract balances presented separately because it would help them understand information about the following:
>
> a. The amount of the opening balance of the contract liability balance that will be recognized as revenue during the period
>
> b. The amount of the opening balance of the contract asset that will be transferred to accounts receivable or collected in cash during the period.

Because of this feedback, items (a) and (b) above were incorporated into the requirements in ASC 606-10-50-8(a) and (b) shown below. In a manner similar to how the FASB designed the disclosure requirements related to the disaggregation of revenue, the Board provided some optionality in terms of how contract balances and changes in contract balances should be presented (i.e., a tabular format is not required).

While many entities may already have disclosures similar to those required by ASC 606-10-50-8(a) and (b) or have information readily available to produce the disclosures, an entity is also required to disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied in previous periods). This quantitative information, which is required under ASC 606-10-50-8(c), may not be readily available and could require substantial preparation by the entity. Questions that entities should consider in preparing these disclosures (and others) include, but are not limited to, the following:

- If the financial statements already have disclosures presented, are those disclosures sufficient?
- What controls are in place to test the completeness and accuracy of the information disclosed?
- Is the current accounting information system capable of providing this information? Is that system within the scope of internal control over financial reporting?
- If the entity had any acquisitions or divestitures during the fiscal year, do those acquisitions or divestitures affect the revenue disclosures?
- What qualitative information would the financial statement user find interesting to supplement quantitative information?
- Have there been material changes in the timing of when performance obligations will result in revenue recognition?
- What payment terms (e.g., payments in arrears, milestones, contingent payments, post-paid customers) give rise to contract assets?
- What transactions (e.g., business combinations) would change future balances?
- Why did the balance(s) change?
- In a typical contract, how does the satisfaction of performance obligations correlate with customer payment?

ASC 606-10

50-8 An entity shall disclose all of the following:

a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
c. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

50-9 An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

50-10 An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations
b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification
c. Impairment of a contract asset
d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)
e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

14.2.2.1 Disclosure of Opening and Closing Balances — Receivables, Contract Assets, and Contract Liabilities

In a manner consistent with the disclosure requirement to present or disclose revenue from contracts with customers, an entity must present separately on the face of the financial statements or disclose the opening and closing balances of receivables, contract assets, and contract liabilities. In addition, an entity may consider disclosing where such balances are included in the statement of financial position.

14.2.2.2 Disclosure of Revenue Recognized From Contract Liability Balance

Drawing on the components of a rollforward of contract balances, the new revenue standard requires quantitative disclosure of amounts recognized in the current reporting period (or comparative periods presented) that were in the prior period-end's contract liability balance.

For example, suppose that an entity had a deferred revenue (contract liability) balance of $2,000 as of December 31, 20X7. In accordance with ASC 606-10-50-8(b), the entity is required to disclose what amount of that $2,000 was recorded in 20X8 (or the first quarter of 20X8, depending on the reporting period presented). If $1,500 of the $2,000 was recognized in the first quarter of 20X8, the entity should disclose $1,500 as the amount of revenue recognized during that period that was previously included in the deferred revenue (contract liability) balance as of December 31, 20X7.

14.2.2.3 Disclosure of Revenue Recognized From Past Performance

In accordance with ASC 606-10-50-8(c) an entity is required to disclose "out of period" adjustments attributable to changes in estimates. That is, if an estimate of variable consideration is adjusted (or a royalty is received after a right-to-use license has been transferred to the customer) and an adjustment to revenue is accordingly recognized in the period, the adjustment to revenue should be disclosed. The example below illustrates the application of ASC 606-10-50-8(c).

Example 14-1

An entity has entered into a long-term construction contract that includes two forms of consideration: a fixed component of $3,000 and a potential performance bonus of $1,000. Therefore, the total potential consideration in this contract is $4,000. However, as of contract inception, no variable consideration is included in the transaction price — that is, the transaction price is constrained (see Chapter 6 for further discussion on estimating and constraining the transaction price).

As of September 30, 20X8, the entity's performance under the contract is 50 percent complete. Therefore, using the original estimate of the transaction price, the entity recognizes revenue of $1,500 (50 percent of $3,000).

Subsequently, on the basis of further information and estimation during the entity's year-end close process, it is believed to be probable that the entity will receive the performance bonus. Therefore, the entity includes a cumulative catch-up adjustment in accordance with ASC 606-10-32-42 through 32-45 (see Chapter 6) and updates its transaction price to $4,000. As a result, on December 31, 20X8, the entity records $500 in revenue to catch up during the fourth quarter of 20X8 for the prior performance under the contract.

Example 14-1 (continued)

In accordance with ASC 606-10-50-8(c), this $500 cumulative catch-up adjustment should be disclosed. The entity may make this disclosure as follows:

Consideration	
Fixed component	3,000
Variable component	1,000
Total potential transaction price	4,000
Contract inception transaction price	3,000

	Original	Adjusted
Revenue	3,000	4,000
As of 50% complete		
Revenue	1,500	2,000
Adjustment to catch up for increase in transaction price		500

The disclosure may be presented in a narrative format in the entity's financial statements. For example, the entity could provide a narrative disclosure that states, "For the three-month period ending December 31, 20X8, the Company recognized $500 in revenue from performance obligations satisfied in the prior period; the cumulative catch-up adjustment resulted from a change in transaction price related to variable consideration that was constrained in prior periods."

14.2.2.4 Practical Expedient

ASC 606-10

50-11 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide any or all of the disclosures in paragraphs 606-10-50-8 through 50-10. However, if an entity elects not to provide the disclosures in paragraphs 606-10-50-8 through 50-10, the entity shall provide the disclosure in paragraph 606-10-50-8(a), which requires the disclosure of the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed.

14.2.2.5 Additional Examples

The illustrative disclosure below shows how an entity might provide the information required under ASC 606-10-50-8.

Illustrative Disclosure — Contract Balances

The Company enters into contracts to sell machinery and services to maintain the machinery. In addition, we provide our customers software licenses, associated maintenance, and services. Approximately 60 percent of our customer base takes advantage of the discounted pricing the Company offers by paying within 30 days of being invoiced. The payment terms and conditions in our customer contracts vary. In some cases, customers prepay for their goods and services; in other cases, after appropriate credit evaluations, payment is due in arrears. In addition, there are performance bonuses and other forms of contingent consideration. When the timing of the Company's delivery of machinery and provision of services is different from the timing of the payments made by customers, the Company recognizes either a contract asset (performance precedes contractual due date in connection with estimates of variable consideration) or a contract liability (customer payment precedes performance). Those customers that prepay are represented by the contract liabilities below until the performance obligations are satisfied, and the contract assets represent arrangements in which an estimate of contingent or variable consideration has been included in the transaction price and thereby recognized as revenue that precedes the contractual due date. Contracts with payment in arrears are recognized as receivables (including long-term receivables) after the Company considers whether a significant financing component exists and, in some cases, adjusts for a significant financing component.

What payment terms give rise to contract assets? Such terms may include payments in arrears, milestones, contingent payments, and post-paid customers.

The opening and closing balances of the Company's contract asset, current and long-term contract liability, and receivables are as follows:

What payment terms give rise to contract liabilities? Such terms may include milestones, up-front payments, and prepaid customers.

Contract Balances

	Receivables	Contract Asset	Contract Liability (Current)	Contract Liability (Long-Term)
Opening (1/1/20X8)	$ XX	$ XX	$ XX	$ XX
Closing (12/31/20X8)	XX	XX	XX	XX
Increase/(decrease)	XX	XX	XX	XX
Opening (1/1/20X7)	$ XX	$ XX	$ XX	$ XX
Closing (12/31/20X7)	XX	XX	XX	XX
Increase/(decrease)	XX	XX	XX	XX
Opening (1/1/20X6)	$ XX	$ XX	$ XX	$ XX
Closing (12/31/20X6)	XX	XX	XX	XX
Increase/(decrease)	XX	XX	XX	XX

What events would change future balances?

The amounts of revenue recognized in the period that were included in the opening contract liability current and long-term balances were $XX and $XX, respectively. This revenue consists primarily of license updates and maintenance, as well as Type D services and professional services. The Company also recognized revenue of $XX from obligations satisfied (or partially satisfied) in prior periods. This amount of revenue is a result of changes in the transaction price of the Company's contracts with customers.

Why did this balance change from the prior period?

Illustrative Disclosure — Contract Balances (continued)

For the contracts of business units A and B, the timing of payment is typically up front. Therefore, a contract liability is created when a contract includes license updates and maintenance or professional services because these performance obligations are satisfied over time. For business unit C's contracts, the timing of payment is typically in advance of services on an annual, quarterly, or monthly basis. Therefore, because these services are provided over time, a contract liability is created when payment is made in advance of performance.

In a typical contract, how does the satisfaction of performance obligations correlate with customer payment?

The difference between the opening and closing balances of the Company's contract assets and contract liabilities primarily results from the timing difference between the Company's performance and the customer's payment. However, other significant changes to the opening and closing balances include changes of $XX attributable to business combinations; impairment of contract assets of $XX; contract assets of $XX reclassified to receivables; and cumulative catch-up adjustments of $XX arising from contract modifications, measure-of-progress changes, or changes in the estimate of the transaction price.

Was the change driven by a business combination, a change in contract terms, or a change in the customer base?

The example below, which is reproduced from the FASB's and IASB's 2011 exposure draft on revenue (issued by the FASB as a proposed ASU), illustrates a reconciliation of contract assets and contract liabilities. Although such a reconciliation is not required, the example shows how some entities may present some of the required information on contract balances.

Example in the FASB's and IASB's 2011 Exposure Draft

Example 19 — Reconciliation of Contract Assets and Contract Liabilities

An entity has two main business units: a services business and a retail business. Customers of the services business typically pay a portion of the promised consideration in advance of receiving the services and the remaining amount upon completion of the services. The service contracts do not include a significant financing component. Customers of the retail business typically pay in cash at the time of transfer of the promised goods.

During 20X1, the entity recognized revenue of $18,500 from contracts with customers ($1,000 of which was cash sales from the entity's retail business). The entity received $3,500 payments in advance.

Included in the transaction price of one of the entity's services contracts is a performance bonus that the entity will receive only if it meets a specified milestone by a specified date. The entity includes that performance bonus in the transaction price and recognizes revenue over time using an appropriate method of measuring progress. As of December 31, 20X0, the entity was not reasonably assured to be entitled to the cumulative amount of consideration that was allocated to the entity's past performance at that date. However, during 20X1 the entity became reasonably assured to be entitled to the performance bonus. Consequently, the entity recognized a contract asset and revenue of $500 for the portion of the bonus relating to the entity's performance in the previous reporting period.

As a result of a business combination on December 31, 20X1, the entity's contract assets increased by $4,000 and its contract liabilities increased by $1,900.

Example in the FASB's and IASB's 2011 Exposure Draft (continued)

Contract assets	—
Contract liabilities	$ (2,000)
Net contracts at December 31, 20X0	**(2,000)**
Revenue from contracts with customers	
Performance obligations satisfied during the reporting period	18,000
Amounts allocated to performance obligations satisfied in previous periods	500
	18,500
Amounts recognized as receivables	(14,000)
Payments in advance	(3,500)
Cash sales	(1,000)
Effects of a business combination	
Increase of contract assets	4,000
Increase of contract liabilities	(1,900)
Net contracts at December 31, 20X1	**$ 100**
Contract assets	4,500
Contract liabilities	$ (4,400)

14.2.3 Performance Obligations

The table below summarizes the disclosure requirements discussed in this section through Section 14.2.4.2, including practical expedients available to nonpublic entities as well as required interim disclosures.

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Performance obligations (including remaining performance obligations)	Qualitative information about (1) when performance obligations are typically satisfied, (2) significant payment terms, (3) the nature of goods or services promised, (4) obligations for returns or refunds, and (5) warranties.	No	No
	Transaction price allocated to the remaining performance obligations:		
	• Disclosure of quantitative amounts.	Yes	Yes
	• Quantitative or qualitative explanation of when remaining performance obligation amounts will be recognized as revenue.	Yes	Yes

Quantitative and qualitative information about an entity's performance obligations should also be disclosed. These required disclosures should complement an entity's accounting policy disclosure and, like the other disclosures required under the new revenue standard, should be tailored and written in a manner that avoids boilerplate language. Questions that entities may consider helpful in developing the required disclosures related to performance obligations include the following:

- What are the typical promises made to the customer?
- Does the entity satisfy the performance obligation(s) upon shipment, upon delivery, as services are rendered, or upon completion of service?
- If bill-and-hold arrangements are in place, have performance obligations associated with these contracts been disclosed?
- How is the entity's performance tied to its payment terms?
- When is payment typically due?
- Does the contract contain a significant financing component?
- Is the consideration amount variable? If so, what drives the variability (e.g., assumptions and judgments)?
- Is the estimate of variable consideration typically constrained? Is it consistent with estimates in prior periods?
- Is there a performance obligation to arrange for another party to transfer goods or services (i.e., is the entity acting as an agent)?
- Are there any material rights created by (1) favorable renewal terms or (2) customer loyalty or incentive programs?

ASC 606-10

50-12 An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement
b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)
c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)
d. Obligations for returns, refunds, and other similar obligations
e. Types of warranties and related obligations.

The illustrative disclosure below shows how an entity might provide the information required under ASC 606-10-50-12.

Illustrative Disclosure — Performance Obligations

At contract inception, the Company assesses the goods and services promised in its contracts with customers and identifies a performance obligation for each promise to transfer to the customer a good or service (or bundle of goods or services) that is distinct. To identify the performance obligations, the Company considers all of the goods or services promised in the contract regardless of whether they are explicitly stated or are implied by customary business practices. The Company determines that the following distinct goods and services represent separate performance obligations:

- Performance obligation A.
- Performance obligation B.
- Performance obligation C.
- Performance obligation D.
- Performance obligation E.

When Performance Obligations Are Satisfied

For performance obligations related to Type A contracts and Type B contracts, the Company typically satisfies its performance obligations evenly over the contract term. For performance obligations related to Type C contracts, the Company typically satisfies its performance obligations over time as services are rendered. For performance obligations related to products and licenses in Type D contracts and Type E contracts, the Company typically transfers control at a point in time upon shipment or delivery of the product. The customer is able to direct the use of, and obtain substantially all of the benefits from, the product at the time the product shipped.

Significant Payment Terms

The contract with the customer states the final terms of the sale, including the description, quantity, and price of each product or service purchased. Payment for Segment 1 contracts is typically due in full within 30 days of delivery or the start of the contract term. For Segment 2 contracts, payment terms are in advance of services on an annual, quarterly, or monthly basis over the contract term, which is typically one year.

Since the customer agrees to a stated rate and price in the contract that do not vary over the contract, the majority of contracts do not contain variable consideration. However, customers in Division A are charged usage-based royalties; therefore, the contracts contain variable consideration that is constrained and recognized as revenue when the subsequent usage occurs.

Nature of Goods and Services

In Segment 1, the goods and services promised include XXX, XXX, XXX, and XXX. [Provide descriptions of products and services to comply with the disclosure objective and guidance in ASC 606-10-50-12(c).]

In Segment 2, the goods and services promised include XXX, XXX, XXX, and XXX. [Provide descriptions of products and services to comply with the disclosure objective and guidance in ASC 606-10-50-12(c).]

Returns, Refunds, and Warranties

In the normal course of business, the Company does not accept product returns unless the item is defective as manufactured. The Company establishes provisions for estimated returns and warranties. In addition, the Company does not typically provide customers with the right to a refund.

What are the distinct deliverables in your contracts? When are they typically satisfied?

Have all performance obligations been disclosed? Consider any material rights or warranty obligations.

Is there a significant financing component?

Do contracts typically include variable consideration or warranties (assurance versus service)?

14.2.4 Transaction Price Allocated to the Remaining Performance Obligations

The requirement in ASC 606-10-50-13 to provide information on the transaction price allocated to the remaining performance obligations is a new and challenging disclosure requirement; however, it is viewed as a critical disclosure by users of financial statements. Many refer to this disclosure as the "backlog" disclosure because it requires disclosure of expected future revenue to be recorded on partially completed contracts.

For example, suppose that a calendar-year-end entity sells a two-year magazine subscription to a customer on April 1, 20X8, for an up-front payment of $24. Therefore, as of December 31, 20X8, the entity has fulfilled nine months of the contract by delivering nine magazines to the customer and has recognized $9 of revenue. In accordance with ASC 606-10-50-13, the entity is required to include in its disclosures for December 31, 20X8, a quantitative disclosure of the remainder ($15) as the transaction price allocated to the remaining performance obligations since it expects to fulfill the remaining 15 months of the subscription and recognize the remaining $15 in revenue in future periods (i.e., in the years ending (1) December 31, 20X9, and (2) December 31, 20Y0).

Specifically, ASC 606-10-50-13 requires disclosure as follows:

ASC 606-10

50-13 An entity shall disclose the following information about its remaining performance obligations:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
b. An explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:
    1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
    2. By using qualitative information.

Since determining when performance obligations are satisfied is a matter of judgment, as discussed above and in Sections 14.3 and 14.3.1, the required disclosures related to remaining performance obligations may be subjective and difficult to determine. In light of this, entities should consider the following questions when developing their disclosures in accordance with ASC 606-10-50-13 through 50-15:

- For existing contracts, do the entity's disclosures accurately portray:
    - The amount and expected timing of revenue to be recognized from the remaining performance obligations?
    - Trends related to the amounts and expected timing of revenue to be recognized from the remaining performance obligations?
    - Risks associated with expected future revenue? (Risks may increase if remaining performance obligations are not satisfied until much later.)
    - The effect of changes in judgments or circumstances?

- Is the timing of revenue recognition uncertain? (If so, qualitative disclosures may be appropriate.)
- Are there contracts and associated performance obligations that have an original expected duration of one year or less? (See Section 14.2.4.1.)
- Can the entity recognize revenue as invoiced in accordance with ASC 606-10-55-18? (See Section 14.2.4.1.)
- What is the relationship between the required disclosures about remaining performance obligations and other disclosures, such as MD&A disclosures and backlog disclosures in filings outside the financial statements, if applicable? (For example, entities that voluntarily disclose information about future revenues in backlog disclosures within filings outside of the financial statements should consider where this information is coming from, whether it would satisfy the new disclosure requirements, and whether the appropriate controls for reviewing this information are currently implemented and operating effectively.)

14.2.4.1 Practical Expedients

Under ASC 606-10-50-16, certain nonpublic entities can elect not to provide the disclosures described in ASC 606-10-50-13 through 50-15. In addition, a practical expedient under ASC 606-10-50-14 is available to all entities for contracts that meet either of the following conditions:

- The original expected duration of the contract is one year or less.
- Revenue from the satisfaction of the performance obligations is recognized in the amount invoiced in accordance with ASC 606-10-55-18 (see Section 8.5.6.1).

ASC 606-10

50-14 As a practical expedient, an entity need not disclose the information in paragraph 606-10-50-13 for a performance obligation if either of the following conditions is met:

a. The performance obligation is part of a contract that has an original expected duration of one year or less.
b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18.

50-15 An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 606-10-50-14 and whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

50-16 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide the disclosures in paragraphs 606-10-50-13 through 50-15.

Q&A 14-2 Disclosure of Transaction Price Allocated to Remaining Performance Obligations When the Practical Expedient for Recognizing Revenue in a Manner Consistent With Invoicing Is Not Applied

ASC 606-10-50-13 requires an entity to disclose specified information about the aggregate amount of the transaction price allocated to its remaining performance obligations and when it expects to recognize those amounts as revenue. However, in accordance with the disclosure practical expedient in ASC 606-10-50-14, an entity may choose not to disclose this information if either of the following conditions is met:

- "The performance obligation is part of a contract that has an original expected duration of one year or less."
- Revenue from the satisfaction of the performance obligation is recognized in a manner consistent with the entity's right to invoice, in accordance with the recognition practical expedient in ASC 606-10-55-18.

Question

When the recognition practical expedient in ASC 606-10-55-18 is not applied, is the disclosure practical expedient in ASC 606-10-50-14 available only if the performance obligation is part of a contract with an original expected duration of one year or less?

Answer

Yes. For a performance obligation that is part of a contract with an original expected duration of more than one year, the disclosure practical expedient is only available when the recognition practical expedient in ASC 606-10-55-18 is applied.

In applying ASC 606-10-50-13, entities may need to use judgment to calculate the amounts allocated to unsatisfied (or partially unsatisfied) performance obligations, particularly when the transaction price is variable. However, it should be noted that (1) amounts excluded from the transaction price in accordance with ASC 606-10-32-2 through 32-27 (notably, variable consideration constrained in accordance with ASC 606-10-32-11 and adjustments to reflect a significant financing component in the contract) should not be included in the amounts disclosed and (2) ASC 606-10-50-15 requires only a qualitative explanation of the amounts excluded from the transaction price.

In addition, when the timing of future revenue recognition is uncertain, it may be appropriate to apply the option in ASC 606-10-50-13(b)(2) to disclose only qualitative information about that expected timing.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

Construction Ahead — Proposed Additional Practical Expedients

As a result of the TRG's discussion in July 2015 on the application of the series provision and allocation of variable consideration, as well as the FASB's ongoing project related to technical corrections and improvements to the Codification, the FASB issued a proposed ASU on May 18, 2016, which, among other things, would clarify the guidance on disclosures about remaining performance obligations. According to the proposed ASU, "[s]takeholders have requested that the Board consider whether specific practical expedients could be added to the guidance for contracts in which an entity does not need to estimate variable consideration in order to recognize revenue."

The proposed ASU would add ASC 606-10-50-14A and 50-14B and amend the guidance in ASC 606-10-50-15 as follows (added text is underlined, and deleted text is ~~struck out~~):

> **606-10-50-14A** As a practical expedient, an entity need not disclose the information in paragraph 606-10-50-13 for variable consideration in which either of the following conditions is met:
>
> a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property accounted for in accordance with paragraphs 606-10-55-65 through 55-65B.
>
> b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met.
>
> **606-10-50-14B** The practical expedients in paragraphs 606-10-50-14(b) and 606-10-50-14A shall not be applied to fixed consideration or variable consideration that does not meet one of the conditions in paragraph 606-10-50-14A.
>
> **606-10-50-15** An entity shall disclose which ~~explain qualitatively whether it is applying the~~ practical ~~expedient~~ expedients in ~~paragraph~~ paragraphs 606-10-50-14 through 50-14A it is applying. In addition, an entity applying the practical expedients in paragraphs 606-10-50-14 through 50-14A shall disclose the nature of the performance obligations, the remaining duration (see paragraph 606-10-25-3), and a description of the variable consideration (for example, the nature of the variability and how that variability will be resolved) that has been excluded from the information disclosed in accordance with paragraph 606-10-50-13. This information shall include sufficient detail to enable users of financial statements to understand the remaining performance obligations that the entity excluded from the information disclosed in accordance with paragraph 606-10-50-13. In addition, an entity shall explain ~~and~~ whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

Comments on the proposed ASU were due by July 2, 2016. The effective date for the final ASU would be the same as the effective date and transition requirements for ASC 606 (and any other Codification topic amended by ASU 2014-09). See Chapter 19 for additional information, and stay tuned for future developments on this topic (including whether the FASB finalizes its proposals or makes additional or modified changes to them before issuing a final ASU).

14.2.4.2 Illustrative Examples

An entity may provide a quantitative disclosure of the transaction price to be allocated to the remaining performance obligations as follows:

Illustrative Disclosure — Remaining Performance Obligations

For contracts that are greater than one year, the table below discloses (1) the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period and (2) when the Company expects to recognize this revenue.

Remaining Performance Obligations

	20X8	20X9	20Y0	20Y1	Total
Revenue expected to be recognized on multiyear Type A contracts in place as of December 31, 20X7	$ XX	$ XX	$ XX	$ XX	$ XX
Revenue expected to be recognized on multiyear Type B contracts in place as of December 31, 20X7	XX	XX	XX	XX	XX
Revenue expected to be recognized on multiyear Type C contracts in place as of December 31, 20X7	XX	XX	XX	XX	XX

This disclosure does not include revenue related to performance obligations that are part of a contract whose original expected duration is one year or less. In addition, this disclosure does not include expected consideration related to performance obligations for which the Company elects to recognize revenue in the amount it has a right to invoice (e.g., usage-based pricing terms).

Explain what is included within the scope of the disclosure (i.e., it excludes contracts satisfied in less than a year).

Is this information readily available?

Are there controls to ensure that the information is reliable?

How does this compare with other disclosures (e.g., MD&A, backlog)?

How did you determine what to include or exclude, and should that be disclosed?

What changes have occurred year over year?

Describe variable consideration that is not included in the disclosed amounts because of the constraint.

The Codification examples below further illustrate how an entity could disclose its allocation of the transaction price to the remaining performance obligations to meet the requirements of ASC 606-10-50-13.

ASC 606-10

Example 42 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations

55-298 On June 30, 20X7, an entity enters into three contracts (Contracts A, B, and C) with separate customers to provide services. Each contract has a two-year noncancellable term. The entity considers the guidance in paragraphs 606-10-50-13 through 50-15 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at December 31, 20X7.

Contract A

55-299 Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of $25.

55-300 Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph 606-10-55-18. Consequently, no disclosure is necessary if the entity elects to apply the practical expedient in paragraph 606-10-50-14(b).

Contract B

55-301 Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of $400 per month for both services. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

55-302 The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The information for Contract B included in the overall disclosure is as follows.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$ 4,800[(a)]	$ 2,400[(b)]	$ 7,200

(a) $4,800 = $400 × 12 months

(b) $2,400 = $400 × 6 months

Contract C

55-303 Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of $100 per month plus a one-time variable consideration payment ranging from $0–$1,000 corresponding to a one-time regulatory review and certification of the customer's facility (that is, a performance bonus). The entity estimates that it will be entitled to $750 of the variable consideration. On the basis of the entity's assessment of the factors in paragraph 606-10-32-12, the entity includes its estimate of $750 of variable consideration in the transaction price because it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

ASC 606-10 (continued)

55-304 The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The entity also includes a qualitative discussion about any significant variable consideration that is not included in the disclosure. The information for Contract C included in the overall disclosure is as follows.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$ 1,575[(a)]	$ 788[(b)]	$ 2,363

(a) Transaction price = $3,150 ($100 × 24 months + $750 variable consideration) recognized evenly over 24 months at $1,575 per year

(b) $1,575 ÷ 2 = $788 (that is, for 6 months of the year)

55-305 In addition, in accordance with paragraph 606-10-50-15, the entity discloses qualitatively that part of the performance bonus has been excluded from the disclosure because it was not included in the transaction price. That part of the performance bonus was excluded from the transaction price in accordance with the guidance on constraining estimates of variable consideration.

Example 43 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations — Qualitative Disclosure

55-306 On January 1, 20X2, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of $10 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of December 31, 20X2, the entity has recognized $3.2 million of revenue. The entity estimates that construction will be completed in 20X3 but it is possible that the project will be completed in the first half of 20X4.

55-307 At December 31, 20X2, the entity discloses the amount of the transaction price that has not yet been recognized as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognize that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

> As of December 31, 20X2, the aggregate amount of the transaction price allocated to the remaining performance obligation is $6.8 million, and the entity will recognize this revenue as the building is completed, which is expected to occur over the next 12–18 months.

14.3 Significant Judgments

The table below summarizes the disclosure requirements discussed in this section through Section 14.3.2, including practical expedients available to nonpublic entities as well as required interim disclosures.

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Significant judgments and estimates	Qualitative information about determining the timing of:		
	• Performance obligations satisfied over time (e.g., methods of measuring progress, why methods are representative of transfer of goods or services, judgments used in the evaluation of when a customer obtains control of goods or services).	Yes	No
	• Performance obligations satisfied at a point in time — specifically, the significant judgments used in the evaluation of when a customer obtains control.	Yes	No
	Qualitative and quantitative information[5] about:		
	• Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration).	Yes	No
	• Constraining estimates of variable consideration.	Yes	No
	• Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration.	Yes	No
	• Measuring obligations for returns, refunds, and other similar obligations.	Yes	No

[5] This includes the methods, inputs, and assumptions used in an entity's assessment.

An entity is required to disclose information about the judgments, and changes in judgments, it made in applying ASC 606 to help financial statement users better understand the application of the entity's accounting policies as well as the assumptions and methods used. The new revenue standard significantly expands current disclosure requirements related to judgments associated with revenue recognition. Questions that entities should consider in implementing the new requirements include the following:

- Are all significant judgments and estimates related to variable consideration or noncash consideration included in the disclosures?
- Are all significant judgments and estimates related to the determination of stand-alone selling prices included in the disclosures?
- Has the entity adequately disclosed information about the methods, inputs, and assumptions used in the annual financial statements?
    - What judgments does the entity make in selecting an appropriate measure of progress?
    - What estimates does the entity make in determining the level of completion?
    - What information does management consider to determine when performance obligations are satisfied?
- Has the entity adequately described significant judgments and estimates related to (1) performance obligations satisfied at a point in time, (2) performance obligations satisfied over time, and (3) the transaction price and amounts allocated to performance obligations?

ASC 606-10

50-17 An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

a. The timing of satisfaction of performance obligations (see paragraphs 606-10-50-18 through 50-19)
b. The transaction price and the amounts allocated to performance obligations (see paragraph 606-10-50-20).

The illustration below summarizes the requirements in ASC 606 related to the disclosure of significant judgments about revenue.

Performance obligations satisfied at a point in time	Disclose the significant judgments the entity made in evaluating when a customer obtains control of promised goods or services.
Performance obligations satisfied over time	Disclose the following: • The methods used to recognize revenue (e.g., a description of the output methods or input methods used and how those methods are applied). • An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.
Transaction price and amounts allocated to performance obligations	Disclose the methods, inputs, and assumptions used for all of the following: • Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration. • Assessing whether an estimate of variable consideration is constrained. • Allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable). • Measuring obligations for returns, refunds, and other similar obligations.

14.3.1 Determining the Timing of Satisfaction of Performance Obligations (i.e., the Timing of Revenue Recognition)

ASC 606-10

50-18 For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)
b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

50-19 For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.

Illustrative Disclosure — Performance Obligations Satisfied Over Time

Approximately 60 percent of Company A's revenue is for performance obligations related to long-term standing services; the Company transfers control and recognizes revenue over time. A time-elapsed output method is used to measure progress because the Company transfers control evenly by providing a stand-ready service. The next 20 percent of revenue is for performance obligations related to professional services contracts; the Company satisfies its performance obligations as services are rendered and uses a cost-based input method to measure progress. The remaining approximately 20 percent of revenue, resulting from the Company's billing the customer on a per transaction or labor hour basis, is recognized in the amount invoiced since that amount corresponds directly to the value of the Company's performance to date.

Determining a measure of progress requires management to make judgments that affect the timing of revenue recognized. The Company has determined that the above methods provide a faithful depiction of the transfer of goods or services to the customer. For performance obligations recognized in accordance with a time-elapsed output method, the Company's efforts are expended evenly throughout the period. For Type X services, the Company stands ready to provide Type X services on a when-and-if-available basis. For Segment 2 services, the Company is continuously standing ready at any time. For performance obligations recognized in accordance with the other output methods (i.e., Type Y services), the best measure of depicting the Company's performance as control is transferred is typically hours. For example, for Type X services and Type Y services, the customer obtains value as each increment is provided.

What information does management consider to determine when performance obligations are met?

What judgments does management make in selecting an appropriate measures of progress?

What estimates does management make in determining the level of completion?

Illustrative Disclosure — Performance Obligations Satisfied at a Point in Time

For performance obligations related to Type A products, the Company determines that the customer is able to direct the use of, and obtain substantially all of the benefits from, the products at the time the products are delivered. For performance obligations related to Type B products, the customer obtains control upon shipment.

Determining when control transfers requires management to make judgments that affect the timing of revenue recognized. The Company determines that control transfers to a customer as described above and provides a faithful depiction of the transfer of goods. For Type A products, the Company considers control to transfer when the products are delivered to the customer's requested destination. The Company's standard delivery method is "free on board" shipping point. Consequently, the Company considers control of Type B and Type C products to transfer when the products are shipped in accordance with an agreement and purchase order.

Once a product has shipped or delivered, the customer is able to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The Company considers control to have transferred upon shipment or delivery because the Company has a present right to payment at that time, the customer has legal title to the asset, the Company has transferred physical possession of the asset, and the customer has significant risks and rewards of ownership of the asset.

What are the key control indicators that influence management's judgment?

Why is revenue from the Company's contracts recognized at a point in time rather than over time?

Are there contracts with single performance obligations that include multiple goods or services?

14.3.2 Determining the Transaction Price and the Amounts Allocated to Performance Obligations

ASC 606-10

50-20 An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration
b. Assessing whether an estimate of variable consideration is constrained
c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)
d. Measuring obligations for returns, refunds, and other similar obligations.

50-21 An entity except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide any or all of the following disclosures:

a. Paragraph 606-10-50-18(b), which states that an entity shall disclose, for performance obligations satisfied over time, an explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to a customer
b. Paragraph 606-10-50-19, which states that an entity shall disclose, for performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services
c. Paragraph 606-10-50-20, which states that an entity shall disclose the methods, inputs, and assumptions used to determine the transaction price and to allocate the transaction price. However, if an entity elects not to provide the disclosures in paragraph 606-10-50-20, the entity shall provide the disclosure in paragraph 606-10-50-20(b), which states that an entity shall disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

Illustrative Disclosure — Transaction Price

Determining the Transaction Price

For standard contracts in Segments 1 and 2, the Company typically offers cash discounts for customers that pay within 30 days of being invoiced. For these contracts, the transaction price is determined upon establishment of the contract that contains the final terms of the sale, including the description, quantity, and price of each product or service purchased. The Company estimates variable consideration or performs a constraint analysis for these contracts on the basis of both historical information and current trends to estimate the amount of cash discounts to which customers are likely to be entitled.

There are situations in which the Company's contracts include other types of variable consideration. These types of contracts are typically (1) contracts for the sale of machinery and (2) service contracts. The Company estimates and records reductions to revenue for these customer programs and incentive offerings for discounts given for bundled purchases.

What are the key methods, inputs, and assumptions in management's estimate of variable consideration?

Illustrative Disclosure — Transaction Price (continued)

The majority of the Company's contracts have an original duration of three to four years; however, the Company applies the practical expedient for contracts with durations of one year or less and therefore does not consider the effects of the time value of money. For multiyear contracts, the Company uses judgment to determine whether there is a significant financing component. These contracts are generally those in which the customer has made an up-front payment. Contracts that management determined to include a significant financing component are discounted at the Company's incremental borrowing rate. The Company incurs interest expense and accretes a contract liability. As the Company satisfies performance obligations and recognizes revenue from these contracts, interest expense is recognized simultaneously.

Do contracts include variable consideration, multiple-element arrangements, or noncash consideration?

14.4 Contract Costs

The table below summarizes the disclosure requirements discussed in this section, including practical expedients available to nonpublic entities as well as required interim disclosures.

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Contract costs	Qualitative information about:		
	• Judgments the entity made in determining the amount of the costs incurred to obtain or fulfill a contract.	Yes	No
	• The method the entity uses to determine the amortization for each reporting period.	Yes	No
	Quantitative information about:		
	• The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset.	Yes	No
	• The amount of amortization and any impairment losses recognized in the reporting period.	Yes	No

Entities are also required to disclose significant judgments related to contract costs to help users of financial statements understand the types of costs that the entity has recognized as assets and how those assets are subsequently amortized or impaired.

ASC 340-40

50-1 Consistent with the overall disclosure objective in paragraph 606-10-50-1 and the guidance in paragraphs 606-10-50-2 through 50-3, an entity shall provide the following disclosures of assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraphs 340-40-25-1 or 340-40-25-5.

ASC 340-40 (continued)

50-2 An entity shall describe both of the following:

a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5)
b. The method it uses to determine the amortization for each reporting period.

50-3 An entity shall disclose all of the following:

a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)
b. The amount of amortization and any impairment losses recognized in the reporting period.

50-4 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, may elect not to provide the disclosures in paragraphs 340-40-50-2 through 50-3.

The illustrative disclosure below shows how an entity may disclose the qualitative and quantitative information required under ASC 340-40-50-1 through 50-4.

Illustrative Disclosure — Qualitative and Quantitative Information About Contract Costs

Assets Recognized From the Costs to Obtain or Fulfill a Contract With a Customer

For the business units C and D, the Company determines that the incentive portions of its sales commission plans qualify for capitalization since these payments are directly related to sales achieved during a time period. Domestically, the amortization period for the capitalized asset is the original contract term. Most international contracts are multiyear renewals and thus have amortization periods longer than a year. The commissions related to these contracts are capitalized and amortized. For the sales commissions that are capitalized (i.e., contracts with multiyear maintenance), the Company determines that an amortization method that allocates the capitalized costs on a relative basis to the products and services sold is a reasonable and systematic basis. When the Company recognizes revenue related to goods and services over time by using the time-elapsed output method, the costs related to those goods and services are amortized over the same period. The capitalized costs of the remaining goods and services for which revenue is recognized over time are amortized in the periods in which the goods and services are invoiced.

How are costs evaluated for capitalization? Is the practical expedient consistently applied?

For business unit A, the Company determines that the incentive portions of its sales commission plans qualify for capitalization. These commissions are earned on the basis of the total purchase order value of new bookings, which does not include sales related to renewals. Since there are not commensurate commissions earned on renewal of the Type B services, the Company concludes that the capitalized asset is related to Type B services provided under both the initial contract and renewal periods. Therefore, the amortization period for the asset is the customer life, which is determined to be five years. Since the asset is related to services that are transferred over the customer's life, the Company amortizes the asset on a straight-line basis over the customer life of five years.

Does the company develop products before obtaining a contract with a customer?

The Company concludes that none of its costs incurred meet the capitalization criteria for costs to fulfill a contract.

14.5 Disclosure of Practical Expedients Used

The table below summarizes the disclosure requirements discussed in this section, including practical expedients available to nonpublic entities as well as required interim disclosures.

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Practical expedients	Disclosure of practical expedients used.	No	No

A number of practical expedients are available to both public business entities and nonpublic entities in the application of the recognition and measurement principles within the standard. Specific disclosures similar to accounting policy disclosures are required if an entity elects certain of these practical expedients. For example, an entity is required to disclose that it is electing the practical expedients related to (1) significant financing components (as discussed further in Chapter 6) and (2) contract costs (as discussed further in Chapter 12).

ASC 606-10

50-22 If an entity elects to use the practical expedient in either paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a contract), the entity shall disclose that fact.

50-23 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide the disclosures in paragraph 606-10-50-22.

ASC 340-40

50-5 If an entity elects to use the practical expedient in paragraph 340-40-25-4 on the incremental costs of obtaining a contract, the entity shall disclose that fact.

50-6 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, may elect not to provide the disclosure in paragraph 340-40-50-5.

Further, ASU 2016-10 and ASU 2016-12, issued on April 14, 2016, and May 9, 2016, respectively, amend the new revenue standard and include three additional practical expedients related to the following:

- *Shipping and handling activities* — ASU 2016-10 permits an entity to account for shipping and handling activities that occur after the customer has obtained control of a good as fulfillment activities (i.e., an expense) rather than as a promised service (i.e., a revenue element). An entity may also elect to account for shipping and handling as a promised service. The ASU also explains that shipping and handling activities performed before the control of a product is transferred do not constitute a promised service to the customer in the contract (i.e., they represent fulfillment costs). The election to account for shipping and handling services as a performance obligation or a fulfillment cost typically should not apply to companies whose principal service offering is shipping or transportation. Further, we believe that such election

(1) should be applied consistently and (2) is available to entities that recognize revenue for the sale of goods either at a point in time or over time. Refer to Section 5.2.4.2 for further information.

An entity that elects to apply this accounting policy is required to provide the accounting policy disclosures in ASC 235-10-50-1 through 50-6.

- *Sales tax presentation* — ASU 2016-12 permits entities to exclude from the transaction price all sales taxes that are assessed by a governmental authority and that are "imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes)." However, such an accounting policy election does not apply to taxes assessed on "an entity's total gross receipts or imposed during the inventory procurement process." Refer to Section 6.6 for further information.

  An entity that elects to exclude sales taxes is required to provide the accounting policy disclosures in ASC 235-10-50-1 through 50-6.

- *Modified retrospective approach* — ASU 2016-12 provides a practical expedient for entities that elect the modified retrospective transition method. Entities are required to disclose the method and practical expedients used in transition. Refer to Section 15.2.2 for further information.

For additional information, refer to Deloitte's April 15, 2016, and May 11, 2016, *Heads Up* newsletters.

If entities elect one or more practical expedients, they should disclose that fact in their financial statements. Entities should consider the appropriate placement for the disclosure of their use of practical expedients. For example, some or all of the elections might appropriately be included in "Significant Accounting Policies" (i.e., footnote 1), whereas it may be appropriate to include other elections in the revenue recognition footnote. The guidance does not dictate where such disclosures should be included; it only indicates that they must be included.

The illustrative disclosures below exemplify how an entity may disclose that management has elected a certain practical expedient available under the new revenue standard:

Illustrative Disclosures — Practical Expedients

For the Company's contracts that have an original duration of one year or less, the Company uses the practical expedient applicable to such contracts and does not consider the time value of money. Further, because of the short duration of these contracts, the Company has not disclosed the transaction price for the remaining performance obligations as of the end of each reporting period or the when the Company expects to recognize this revenue.

For the Company's three-year service contract with Company B, the Company invoices a fixed amount for each hour of service. Therefore, the Company has elected to use a disclosure practical expedient. Accordingly, the Company has not disclosed the transaction price for the remaining performance obligations as of (1) December 31, 20X1, (2) December 31, 20X2, and (3) December 31, 20X3. In accordance with the disclosure practical expedient elected, the Company also has not disclosed when the remaining revenue related to this contract will be recognized.

What is the appropriate place in which to disclose the use of practical expedients? Possibilities include (1) the "significant accounting policies" footnote and (2) the "revenue recognition" footnote.

The illustrative disclosure below shows how an entity may describe its use of the practical expedient related to contracts costs in accordance with ASC 606-10-50-22.

Illustrative Disclosure — Use of Practical Expedient Related to Contract Costs

Significant Judgments and Estimates Related to Costs Incurred to Obtain a Contract

The Company recognizes an asset for the incremental costs of obtaining a contract with a customer if it expects to recover those costs. The Company determines that the main sales commissions for Segments 1 and 2 meet the requirements to be capitalized as assets. However, the Company elects the practical expedient to expense the costs as incurred if the amortization period would have been one year or less.

For sales commissions related to Segment 1 products A, products B, one year or less service C, and professional services, the practical expedient is elected because the amortization period is the related contract term, which is typically one year or less. However, the practical expedient does not apply to commissions incurred for selling multiyear service Y. The Company capitalizes the sales commissions related to multiyear service Y contracts and amortizes the asset over the related service Y period, typically over three to four years.

For sales commissions related to services for Segment 2 services, the practical expedient cannot be elected since the amortization period is deemed to be the customer life, which is longer than one year. The Company capitalizes the sales commissions related to Segment 2 services that are directly tied to sales. Some commissions based on other performance metrics are expensed as incurred because the Company incurs the cost regardless of whether it obtains a contract, in such a manner that these costs are not incremental. For the sales commissions that are capitalized, the Company amortizes the asset over the average customer life, which is based on recent and historical data.

Does the company develop products before obtaining a contract with a customer?

How are costs evaluated for capitalization? Is the practical expedient consistently applied?

14.6 Summary of Disclosure Requirements, Including Practical Expedients for Nonpublic Entities and Interim Requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Disaggregation of revenue	Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors.	Yes[6]	Yes
	Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information.	Yes	Yes

[6] At a minimum, an entity must disclose revenue that is disaggregated in accordance with the timing of transfer of goods or services (e.g., goods transferred at a point in time and services transferred over time).

(Table continued)

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Contract balances	Opening and closing balances (receivable, contract assets, and contract liabilities).	No	Yes
	Amount of revenue recognized from beginning contract liability balance.	Yes	Yes
	Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).	Yes	Yes
	Explanation of significant changes in contract balances (using qualitative and quantitative information).	Yes	No
Performance obligations (including remaining performance obligations)	Qualitative information about (1) when performance obligations are typically satisfied, (2) significant payment terms, (3) the nature of goods or services promised, (4) obligations for returns or refunds, and (5) warranties.	No	No
	Transaction price allocated to the remaining performance obligations:		
	• Disclosure of quantitative amounts.	Yes	Yes
	• Quantitative or qualitative explanation of when remaining performance obligation amounts will be recognized as revenue.	Yes	Yes

(Table continued)

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Significant judgments and estimates	Qualitative information about determining the timing of:		
	• Performance obligations satisfied over time (e.g., methods of measuring progress, why methods are representative of the transfer of goods or services, judgments used in the evaluation of when a customer obtains control of goods or services).	Yes	No
	• Performance obligations satisfied at a point in time — specifically, the significant judgments used in the evaluation of when a customer obtains control.	Yes	No
	Qualitative and quantitative information[7] about:		
	• Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration).	Yes	No
	• Constraining estimates of variable consideration.	Yes	No
	• Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration.	Yes	No
	• Measuring obligations for returns, refunds, and other similar obligations.	Yes	No

[7] This includes the methods, inputs, and assumptions used in an entity's assessment.

(Table continued)

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities	Interim Requirement (ASC 270)
Contract costs	Qualitative information about:		
	• Judgments made in determining the amount of the costs incurred to obtain or fulfill a contract.	Yes	No
	• The method the entity uses to determine the amortization for each reporting period.	Yes	No
	Quantitative information about:		
	• The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset.	Yes	No
	• The amount of amortization and any impairment losses recognized in the reporting period.	Yes	No
Practical expedients	Disclosure of practical expedients used.	No	No

Chapter 15 — Effective Date and Transition Requirements

15.1 Effective Date

In accordance with ASC 606-10-65-1, the effective date of the new revenue standard varies depending on the type of entity applying the guidance:

> a. A public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission shall apply the [guidance in the new revenue standard] for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
>
> b. All other entities shall apply the [guidance in the new revenue standard] for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. However, all other entities may elect to apply the [guidance in the new revenue standard] earlier only as of either:
>
> 1. An annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period.
> 2. An annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the [guidance in the new revenue standard].

When ASU 2014-09 was issued, the original effective date for entities addressed by ASC 606-10-65-1(a) above was annual reporting periods beginning after December 15, 2016 (the "public business entity adoption date"); all other entities could adopt the new revenue standard as of the public business entity adoption date but had the option to adopt the new revenue standard one year later. In August 2015, the FASB issued ASU 2015-14, which defers the effective date of ASU 2014-09 by one year for all entities and permits early adoption on a limited basis. These amendments to ASU 2014-09 have been reflected in the guidance above. For the latest stakeholder activity related to the new revenue standard, refer to Chapter 19.

15.2 Transition

When transitioning to the new revenue standard, an entity can elect to use either the "full retrospective method" under ASC 606-10-65-1(d)(1) or the "modified retrospective method" under ASC 606-10-65-1(d)(2). That is, an entity can apply the requirements of the new revenue standard in either of the following ways:

> 1. Retrospectively to each prior reporting period presented in accordance with the guidance on accounting changes in [ASC] 250-10-45-5 through 45-10 subject to the expedients in [ASC 606-10-65-1(f)].
> 2. Retrospectively with the cumulative effect of initially applying the [new revenue standard] recognized at the date of initial application in accordance with [ASC 606-10-65-1(h) and (i)].

ASC 606-10-65-1(c), as amended by ASU 2016-12,[1] states that for the purposes of these transition requirements:

> 1. The date of initial application is the start of the reporting period in which an entity first applies the [new revenue standard].
> 2. A completed contract is a contract for which all (or substantially all) of the revenue was recognized in accordance with revenue guidance that is in effect before the date of initial application.

It is important to determine whether a contract is completed as of the date the new revenue standard is initially applied because such a determination will influence which contracts are affected by the adoption of the new standard depending on which practical expedients are applied (available practical expedients are further discussed below). Further, entities that elect to implement the standard by using the modified retrospective method do not need to adjust contracts with customers that were completed before the date the new standard was initially applied. The Q&A below illustrates how to determine whether a contract is completed at transition.

Q&A 15-1 Modified Retrospective Method — Determining Whether a Contract Is Completed at Transition

Entities adopting the guidance in ASC 606 can elect either of two transition options: the full retrospective transition method or the modified retrospective method. The full retrospective transition method requires retrospective application of the new guidance to each prior reporting period presented. The modified retrospective method allows entities to apply the new revenue standard (1) to all contracts or (2) only to contracts that are not completed as of the date of initial application.

Under the modified retrospective method, an entity should recognize the cumulative effect of initially applying the new revenue recognition guidance as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the annual reporting period that includes the date of initial application.

Question

How should an entity that applies the modified retrospective method only to contracts that are not completed assess whether a contract is completed as of the transition date?

[1] The IASB did not make similar amendments to IFRS 15. Refer to Appendix A for a table of differences between IFRS 15 and ASC 606.

Answer

The new revenue standard states in ASC 606-10-65-1(c)(2) that a contract is considered "completed" if all (or substantially all) of the revenue was recognized in accordance with revenue guidance that was in effect before the date of initial application.

Example

An entity adopts the guidance in ASC 606 on January 1, 2018, and elects to apply the modified retrospective method to contracts that are not completed. The entity assesses all of its contracts as of January 1, 2018, and groups those contracts into two separate groups:

- *Completed contracts* — Contracts for which all or substantially all revenue was recognized before January 1, 2018, are considered completed contracts for purposes of applying the transition guidance. As a result, no modification will be made at transition for these contracts.
- *Incomplete or partially complete contracts* — For contracts for which all or substantially all revenue has not been recognized as of January 1, 2018, a cumulative adjustment to balances is made to reflect the accounting for the contracts under the new guidance as of January 1, 2018. Any resulting difference between the balances as of December 31, 2017, and the balances as of January 1, 2018, are recorded as an adjustment to beginning retained earnings as of January 1, 2018.

No changes to recorded revenue are made for periods before January 1, 2018 (i.e., the balances presented for the years ended December 31, 2017, and December 31, 2016, are not adjusted). In addition, this transition method requires disclosure of an explanation of the impact of adopting the new guidance, including disclosure of the financial statement line items affected, and the respective amounts directly affected, by the standard's application for the reporting period of adoption (i.e., the quarters in 2018 and the year ended December 31, 2018).

Discussed below are examples of common situations that illustrate how an entity would determine whether a contract is completed as of the adoption date.

License of Intellectual Property — Ratable Recognition Under ASC 605 to Up-Front Recognition Under ASC 606

On January 1, 2017, an entity licenses functional intellectual property (IP) for a fixed fee payable over a four-year term. There are no specified promises to the customer in the contract other than the license of the IP.

Before the transition date (under ASC 605), the entity's policy provided for recognition of the fee ratably over the four-year term. Therefore, as of the date of transition (January 1, 2018), the entity has already recognized one-fourth of the total fee.

Under ASC 606, revenue from this arrangement would be recognized at a point in time. Because the entity did not recognize all (or substantially all) of the revenue from this arrangement before the transition date (i.e., three-fourths of the revenue from the license has not been recognized, in accordance with the entity's prior policy under ASC 605), the contract would not be considered completed for accounting purposes. As a result, this contract would need to be adjusted for the impact of applying the revenue model in accordance with ASC 606 and the entity would recognize a cumulative catch-up adjustment in retained earnings that represents the remaining revenue that would have been recognized if the new guidance in ASC 606 had been applied.

License of Software — Extended Payment Terms Causing Deferral Under ASC 985-605

An entity licenses software to a customer on January 1, 2017. There are no specified promises to the customer in the contract other than the license of the software. The customer agrees to make payments annually for three years starting on December 31, 2017.

Before the transition date (under ASC 605), because a significant portion of the fee is not due for more than one year after delivery, it is presumed that the fees would not be fixed or determinable. Because the entity does not have a history of providing extended payment terms, it cannot overcome the presumption and revenue is recognized as amounts become due. Therefore, upon transition (as of January 1, 2018), the entity has only recognized revenue equal to the first installment payment.

Example (continued)

Under ASC 606, revenue from this arrangement would be recognized at the point in time when (1) the customer can first use the software (January 1, 2017). Because the entity did not recognize all (or substantially all) of the revenue from this arrangement before the transition date, the contract would not be considered completed for accounting purposes. As a result, this contract would need to be adjusted for the impact of applying the revenue model in accordance with ASC 606, and the entity would recognize a cumulative catch-up adjustment in retained earnings that represents the remaining revenue that the entity would have recognized (after considering whether a significant financing component exists) if it had applied the new guidance in ASC 606.

Loyalty Rewards Program — Cost Accrual Model Under ASC 605

A retailer has a loyalty rewards program that rewards one point to a customer for each dollar spent. The customer may redeem the points for a discount off future purchases at the retailer store. The retailer sells (and immediately delivers) a product to the customer on December 31, 2016.

Before the transition date (under ASC 605), the retailer used the incremental cost accrual model, under which it recognized (1) revenue at the time of the initial sale and (2) an accrual for the expected costs of satisfying the points awarded. As a result, all revenue from this transaction was recognized under ASC 605.

Under ASC 606, revenue from this type of arrangement would be allocated between the product sold and the loyalty points awards (to the extent that the points are deemed to be a material right) on the basis of stand-alone selling prices. Because all of the revenue from this arrangement was recognized before the transition date, the contract would be considered completed for accounting purposes.

Sale of Product With a Warranty — Cost Accrual Model Under ASC 605

A luggage company provides a lifetime warranty upon the sale of its luggage to a customer. The warranty covers all defects, damages, and "wear and tear." The retailer sells (and immediately delivers) a product to the customer on December 15, 2017.

Before the transition date (under ASC 605), the retailer (1) recognized all of the revenue upon delivery to the customer on December 15, 2017, and (2) accrued a liability associated with the warranty in accordance with ASC 460.

Under ASC 606, the luggage company would most likely (1) conclude that the warranty is a separate performance obligation and (2) therefore allocate revenue between the luggage and the lifetime warranty on the basis of stand-alone selling prices. Because all of the revenue from this arrangement was recognized before the transition date, the contract would be considered completed for accounting purposes.

Note that for the last two examples, the accounting treatment upon transition would be different if the entity elected to apply the modified retrospective method to all contracts. Refer to Q&A 15-2 for discussion of applying the modified retrospective method to all contracts.

The TRG discussed this issue in July 2015; a summary of the TRG's discussion is available in TRG Agenda Paper 44. For additional information and Deloitte's summary, see Appendixes D and E.

15.2.1 Full Retrospective Method

The full retrospective method should be applied in accordance with the general guidance in ASC 250-10-45-5 through 45-8 on applying a change in accounting principle. In accordance with ASC 250-10-45-5, an entity using this approach would be required to retrospectively apply the new revenue standard to all periods presented in the following manner:

> a. The cumulative effect of the change to the new accounting principle [i.e., the new revenue standard] on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
>
> b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
>
> c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle [i.e., the new revenue standard].

With the exception of a few practical expedients, the full retrospective method requires an entity to present financial statements for all periods **as if** the new revenue standard had been applied to all prior periods.

ASC 606-10-65-1(f), as amended by ASU 2016-12, states that when an entity opts to apply the full retrospective method under ASC 606-10-65-1(d)(1), it can use one or more of the following practical expedients:

> 1. An entity need not restate contracts that begin and are completed within the same annual reporting period.
> 2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
> 3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue (see paragraph 606-10-50-13).
> 4. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the [new revenue standard], an entity need not retrospectively restate the contract for those contract modifications in accordance with paragraphs 606-10-25-12 through 25-13. Instead, an entity shall reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented in accordance with the [new revenue standard] when:
>   i. Identifying the satisfied and unsatisfied performance obligations
>   ii. Determining the transaction price
>   iii. Allocating the transaction price to the satisfied and unsatisfied performance obligations.

Some entities have long-term contracts with customers that may be subject to multiple modifications throughout the contract life. As discussed in Chapter 9, contract modifications can be accounted for in multiple ways depending on the nature of the modification. Since the full retrospective method requires an entity to present its financial statements as if the new revenue guidance had been applied to all prior periods, stakeholders indicated that it may be necessary upon transition to the new revenue standard for an entity to evaluate each contract modification that occurred before the initial application to separately determine (1) the modification's impact on the transaction price and (2) how changes in the transaction price should have been attributed to satisfied (or partially satisfied) and unsatisfied performance obligations at the time of the modification.

In response to the feedback, the FASB issued ASU 2016-12, which provides the practical expedient in ASC 606-10-65-1(f)(4). Under that practical expedient, an entity is not required to separately evaluate each contract modification that occurred before the initial adoption date in accordance with ASC 606-10-25-10 through 25-13. Rather, an entity that uses the practical expedient can:

- Identify performance obligations on the basis of the current version of the contract (i.e., including any contract modifications since inception).
- Determine the transaction price, including any variable consideration, as of the transition date.
- Allocate the transaction price to the performance obligations (satisfied, partially satisfied, and unsatisfied) by using the information above.

However, despite the existence of the practical expedient, judgment will still be required at transition, as noted in paragraph BC46 of ASU 2016-12:

> [T]he Board acknowledges that even with this practical expedient, an entity will need to use judgment and make estimates to account for contract modifications at transition. For example, an entity will need to use judgment to estimate standalone selling prices when there has been a wide range of selling prices and to allocate the transaction price to satisfied and unsatisfied performance obligations if there have been several performance obligations or contract modifications over an extended period.

Under ASC 606-10-65-1(g), any practical expedients used should be applied consistently to all contracts within all reporting periods presented. ASC 606-10-65-1(g), also requires the following disclosures:

1. The expedients that have been used
2. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

Under ASC 606-10-65-1(e), as amended by ASU 2016-12, an entity that elects to use the full retrospective method is required to disclose information about a change in accounting principle upon initial adoption of the new revenue standard in accordance with the guidance in ASC 250-10-50-1 and 50-2, except that it does not need to disclose the effect of the changes on the current period as it otherwise would be required to do under ASC 250-10-50-1(b)(2). In addition, the entity is required to disclose the effect of the changes on any prior periods that have been retrospectively adjusted.

Accordingly, an entity that uses the full retrospective method should provide the disclosures required by ASC 250-10-50-1 and 50-2 as follows:

ASC 250-10

50-1 An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.
b. The method of applying the change, including all of the following:
    1. A description of the prior-period information that has been retrospectively adjusted, if any.
    2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for . . . any prior periods retrospectively adjusted.[2] Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.
    3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
    4. If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).
c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:
    1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable
    2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

50-2 An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

Note that entities applying the modified retrospective method are still required under ASC 606-10-65-1(i)(1) and (2) to disclose the amount by which each line item is affected by the application of the new revenue standard. For further discussion of the modified retrospective method, see Section 15.2.2 below.

[2] Reference to "the current period" removed because of the guidance in ASC 606-10-65-1(e).

At the September 2014 Financial Accounting Standards Advisory Council meeting, the SEC staff clarified its views, in response to questions by stakeholders, on how registrants would reflect their implementation of ASC 606 in the five-year table required under SEC Regulation S-K, Item 301. The staff indicated that it would not object if a registrant reflected its adoption of the new revenue standard in the five-year table on a basis that is consistent with the adoption in its financial statements (i.e., reflected in less than each of the five years in the table). Specifically, the staff noted that a registrant could present in the five-year table:

- Only the most recent three years if the registrant uses the full retrospective method to adopt the new revenue standard.
- Only the most recent fiscal year if it uses the modified retrospective method.

Regardless of the transition method adopted, registrants would be expected to disclose the method they used to reflect the information (e.g., how the periods are affected) and that the periods in the table are not comparable. See Chapter 19 for additional SEC views on the potential need to restate a third year of financial information if certain registration statements are filed with the SEC in the initial year of adoption and the full retrospective method is used. In addition, see Chapter 19 for discussion of considerations for nonpublic entities that adopt the full retrospective method and file an S-1 registration statement during the year of mandatory adoption for public entities (i.e., 2018 for a calendar-year-end entity).

15.2.2 Modified Retrospective Method

The modified retrospective method requires entities to apply the new revenue standard only to the current-year financial statements (i.e., the financial statements for the year in which the new revenue standard is first implemented). Entities that apply the modified retrospective method will record a cumulative-effect adjustment to the opening balance of retained earnings in the year the new revenue standard is first applied. The opening adjustment to retained earnings will be determined on the basis of the impact of the new revenue standard's application on contracts that were not completed as of the date of initial application (unless an entity elects to apply the new revenue standard to all contracts).

For an entity that opts to use the modified retrospective method under ASC 606-10-65-1(d)(2), ASC 606-10-65-1(h), as amended by ASU 2016-12, provides the following transition guidance and disclosure requirement:

> [T]he entity shall recognize the cumulative effect of initially applying the [new revenue standard] as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) of the annual reporting period that includes the date of initial application. Under this transition method, an entity may elect to apply this guidance retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application (for example, January 1, 2018, for an entity with a December 31 year-end). An entity shall disclose whether it has applied this guidance to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application. Under this transition method, an entity may apply the practical expedient for contract modifications in [ASC 606-10-65-1(f)(4)]. If an entity applies the practical expedient for contract modifications in [ASC 606-10-65-1(f)(4)], it shall comply with the guidance in [ASC 606-10-65-1(g)].

The Q&A below illustrates how an entity would apply the modified retrospective method to an individual contract under both election alternatives: (1) applying the transition guidance to all contracts as of the date of initial application and (2) applying the transition guidance only to contracts that are not completed as of the date of initial application.

Q&A 15-2 Application of the Modified Retrospective Method of Transition to All Contracts or Only to Contracts Not Completed

The guidance on the modified retrospective method of adoption of the new revenue standard states that "an entity may elect to apply this guidance retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application."[3]

Example

A retail entity operates a loyalty program. Customers enrolled in the program earn loyalty points with every purchase; the points can later be redeemed for free goods or services. The entity, which has a calendar year-end, adopts the new revenue standard as of January 1, 2018, by using the modified retrospective method.

The entity assesses a contract in which it sold and delivered a product in December of 2017 for $50 to a customer who was enrolled in the loyalty program. The loyalty points remain outstanding as of December 31, 2017. Under previous revenue guidance, the entity applied a cost accrual method and consequently concluded that the loyalty points earned by the customer are not a separate deliverable in the arrangement; it therefore recorded $50 of revenue at the time of the transaction and accrued a $3 liability representing the expected cost of providing the future goods or services under the loyalty program. However, upon adopting the new revenue guidance, the entity concludes that the loyalty points earned by the customer give rise to a material right and therefore represent a separate performance obligation. Consequently, the entity concludes that the transaction price of $50 should be allocated between the product ($45) and the loyalty points ($5); no costs would be recognized until the points are redeemed, the related goods or services are transferred to the customer, and the revenue is recognized.

Question

How would the entity account for the contract at transition under each of the elections allowed under the modified retrospective method?

Answer

Election to Apply the Modified Retrospective Method Only to Contracts Not Completed

If electing to apply the modified retrospective method only to contracts not completed as of the date of initial application, the entity would conclude that because all of the revenue related to the contract was recognized before the date of initial application, the contract is considered complete. Therefore, no adjustment is made to beginning retained earnings for this contract as of January 1, 2018, and the $3 liability attributed to outstanding loyalty points as of December 31, 2017, would remain on the balance sheet. When the points are subsequently redeemed, the $3 liability is relieved with no revenue recorded.

[3] Quoted from ASC 606-10-65-1(h).

Election to Apply the Modified Retrospective Method to All Contracts

If electing to apply the modified retrospective method to all contracts as of the date of initial application, the entity would assess this contract and determine that (1) only $45 of revenue would have been recorded under the new revenue standard in the period ended December 31, 2017, and (2) $5 would have been recorded as a contract liability. No costs associated with the outstanding loyalty points would be accrued. Therefore, as of the application date of January 1, 2018 (ignoring the effect of taxes), the entity would (1) record a cumulative-effect entry to reduce beginning retained earnings by $2 (calculated as $5 of previously recognized revenue less $3 of previously accrued costs), (2) record $5 as a contract liability (no amount would be recorded for the anticipated costs of honoring the loyalty points), and (3) reverse the $3 liability previously accrued for the expected costs of providing the goods or services under the loyalty program. When the points are subsequently redeemed, revenue of $5 is recorded along with cost of sales (fulfillment costs) of $3.

Thinking It Through — Determining Whether to Apply the Transition Guidance to All Contracts or Only to Contracts Not Completed

Loyalty Programs

Entities that account for loyalty programs by using either a cost accrual method or similar revenue streams may find that applying the modified retrospective method to all contracts will make accounting for the loyalty programs after the adoption of the new revenue guidance less complicated. This is because applying the modified retrospective method only to open contracts would result in both an accrued cost balance (from transactions before the application date) and a deferred revenue balance (for transactions after the application date) for loyalty points. Specifically, when subsequent loyalty points are redeemed, entities would have to determine (1) whether the redemption should result in a reduction of accrued costs or a reduction of deferred revenue and (2) how to allocate between accrued costs and deferred revenue for redemptions of points earned before and after the application date.

Election Unavailable Under Full Retrospective Method

Unlike the modified retrospective method, the full retrospective method cannot be applied only to contracts not completed at an entity's election. Rather, entities using the full retrospective method must apply that transition guidance to all contracts as of the initial application date (i.e., the beginning of the earliest period presented).

Thinking It Through — Accounting for Costs of Obtaining a Contract When Applying the Modified Retrospective Method of Transition

When applying the modified retrospective method, entities have the option of electing to apply the guidance in the new revenue standard retrospectively either (1) to all contracts as of the date of initial application or (2) only to contracts not completed as of the date of initial application (i.e., open contracts). Electing to apply the modified retrospective method to all contracts or only to open contracts at transition can affect the asset that would be recorded at transition, as illustrated in the example below.

Example 15-1

Consider the following facts:

- Entity A entered into a two-year contract with a customer on July 1, 2015, and paid a $100 commission to obtain the contract, which was immediately expensed under legacy GAAP.
- The customer has an option to renew the contract for an additional two-year term after the initial contract (i.e., renew on July 1, 2017), with pricing of the renewal stated at the stand-alone selling price. The entity did not identify the renewal option as a deliverable under legacy GAAP (since the renewal was not priced at a significant and incremental discount). Substantially all customers renew their contracts for an additional two-year period after the initial term.
- Entity A does not have to pay another commission upon entering into the contract renewal.
- Entity A adopts the guidance in ASU 2014-09 as of January 1, 2018, by using the modified retrospective method.

The determination of whether and, if so, how to record an asset at transition would depend on whether the modified retrospective method is applied (1) to all contracts or (2) only to contracts not completed as of the date of initial application of the new revenue standard.

Scenario 1 — Entity A Elects to Apply the Modified Retrospective Method to All Contracts

If the modified retrospective method is applied to all contracts, the entity would perform the following analysis:

- The pricing of the renewal is stated at the stand-alone selling price. Entity A concludes that the renewal would not be evaluated as a potential material right under ASC 606.
- Entity A concludes that the period of benefit under ASC 340-40 for the asset associated with the commission includes the period of the anticipated contract renewal. This conclusion is consistent with paragraph BC309 of ASU 2014-09, which states:

  > The Boards decided that an entity should amortize the asset recognized from the costs of obtaining and fulfilling a contract in accordance with the pattern of transfer of goods or services to which the asset relates. Respondents broadly agreed; however, some asked the Boards to clarify whether those goods or services could relate to future contracts. Consequently, the Boards clarified that in amortizing the asset in accordance with the transfer of goods or services to which the asset relates, those goods or services could be provided under a specifically anticipated (that is, future) contract. That conclusion is consistent with the notion of amortizing an asset over its useful life and with other standards. However, amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.

Entity A would record at transition an asset related to the unamortized asset that would have been established related to the commission paid in connection with the initial contract. This is because A would have concluded that the asset is related to both the initial two-year contract and the anticipated contract renewal (the asset would have been amortized over a four-year period had A applied the cost guidance in the new revenue standard to all contracts).

Scenario 2 — Entity A Elects to Apply the Modified Retrospective Method Only to Contracts Not Completed as of the Date of Initial Application

Under this scenario, no asset would be established for the commission paid on the initial contract. This is because all of the revenue related to original contract would have been recognized before the date of initial application of the new revenue standard (i.e., the contract is complete). As a result, only the renewal contract would be accounted for under the provisions of the new revenue standard (i.e., the renewal contract is the only open contract at transition). Since no commission was paid for the renewal contract, there would be no incremental costs of obtaining that contract to be capitalized at transition.

When the modified retrospective method is used, ASC 606-10-65-1(i) requires the following additional disclosures for the reporting periods that include the date of initial application:

1. The amount by which each financial statement line item is affected in the current reporting period by the application of the [new revenue standard] as compared with the guidance that was in effect before the change
2. An explanation of the reasons for significant changes identified in [ASC 606-10-65(i)(1)].

The Q&A below considers whether the disclosures in ASC 606-10-50 and ASC 340-40-50 are required for comparative periods when an entity elects to use the modified retrospective method.

Q&A 15-3 Disclosure in Comparative Periods Upon Application of the Modified Retrospective Method of Transition to ASC 606

Question

Is an entity that elects the modified retrospective method upon initially adopting ASC 606 required to provide the disclosures in ASC 606-10-50 and ASC 340-40-50 for the comparative periods presented?

Answer

No. Under the modified retrospective method, the cumulative effect of initially applying ASU 2014-09 is recognized as of the date of initial application, and comparative periods are not restated. Accordingly, an entity would not be required to provide the disclosures under ASC 606-10-50 and ASC 340-40-50 for the comparative periods presented.

However, ASC 606-10-65-1(i) specifies that in the year of initial application of ASC 606, entities electing to use the modified retrospective method are required to disclose the impact of changes to financial statement line items as a result of applying ASC 606 (rather than previous U.S. GAAP) and to include an explanation of the reasons for significant changes. In effect, entities will be required to maintain books and records under both the old and the new revenue guidance so that they can provide the disclosures.

15.2.3 Determining Which Transition Approach to Apply

Entities should carefully evaluate the respective advantages and disadvantages of each of the transition methods before selecting their method of adopting the new revenue standard. The modified retrospective method provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under ASC 606 to determine whether a cumulative adjustment is necessary. In addition, entities adopting the modified retrospective method will be required to include incremental disclosures of (1) the amount by which each financial statement line item is affected in the current reporting period by the application of the new revenue standard and (2) the reasons for the significant changes. It is important to note that these disclosure requirements will effectively require an entity that adopts the modified retrospective method to maintain books and records under both the old and the new revenue guidance so that it can provide the disclosures. In addition, these requirements are for both annual and interim periods; therefore public entities would be required to make the disclosures beginning in the first quarter of the year of adoption (e.g., the period ending March 31, 2018, for a calendar-year-end entity that does not adopt early).

The transparent trend information provided under the full retrospective method may be most effective for entities that expect to experience a significant change. Also, entities that anticipate an acceleration of revenue recognition under ASC 606 may prefer a full retrospective method to ensure that such revenue is not "lost" through equity when recognized as a cumulative-effect adjustment to retained earnings. However, using the full retrospective method will require a significant effort since an entity will need to evaluate not only the direct effect of the change in accounting principle (i.e., changes to revenues, contract assets, contract liabilities, and deferred direct and incremental costs of obtaining a contract) but also whether any indirect effects should be recorded. Direct and indirect effects of a change in accounting principle are described more fully in ASC 250 as follows:

- *Direct effects* — "Those recognized changes in assets or liabilities necessary to effect a change in accounting principle. An example of a direct effect is an adjustment to an inventory balance to effect a change in inventory valuation method. Related changes, such as an effect on deferred income tax assets or liabilities or an impairment adjustment resulting from applying the subsequent measurement guidance in [ASC] 330-10 to the adjusted inventory balance, also are examples of direct effects of a change in accounting principle."
- *Indirect effects* — "Any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively. An example of an indirect effect is a change in a nondiscretionary profit sharing or royalty payment that is based on a reported amount such as revenue or net income."

Further, ASC 250-10-45-8 states the following:

> Retrospective application shall include only the direct effects of a change in accounting principle, including any related income tax effects. Indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods shall not be included in the retrospective application. If indirect effects are actually incurred and recognized, they shall be reported in the period in which the accounting change is made.

The following table summarizes the pros and cons of each method of adoption:

	Advantages	**Disadvantages**
Full retrospective method	• Comparative numbers for all years presented minimize any disruption in trends. • Practical expedients provide the following relief: ◦ Contracts that begin and end in the same annual reporting period do not need to be restated. ◦ Hindsight can be used to determine the transaction price. • There is a longer period between the transition date and the reporting date to test systems of controls and audit transactions (e.g., the period from January 1, 2016, through March 30, 2018, for a public entity with a calendar year-end that does not early adopt). • The approach gives entities an opportunity to perform "trial runs" to address potential unforeseen/unplanned challenges related to the transition.	• Using the full retrospective method may require significant implementation efforts depending on impact. • Information needed to determine the transition's impact may no longer be available. • An entity will potentially need to present a fourth year of comparative information if it is filing a registration statement in the year of adoption. Refer to Chapter 19 for additional discussion.

(Table continued)

	Advantages	Disadvantages
Modified retrospective method	• Entities will have more time to (1) define or establish policies and (2) design and implement changes to processes. • The approach provides relief from restating and presenting comparable prior-year financial statements. • Contracts completed before the transition date do not need to be restated.	• Financial statement trends may be disrupted, and stakeholders may request supplemental information. • Meeting the requirement to disclose the amount by which each financial statement line item is affected by the new revenue guidance for 2018 as compared with the prior/legacy guidance will effectively require maintenance of separate books and records under both the old and the new guidance in 2018.

The selected adoption approach will largely depend on the impact of adoption on the entity and the needs of financial statement users. Entities will also need to consider whether any information system limitations could affect their ability to gather the data needed to apply the full retrospective method. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the new revenue standard and to determine the transition approach that is practical to apply and most beneficial to financial statement users. Management should begin this analysis in consultation with key external stakeholders (e.g., investors and auditors) and be mindful of the required disclosures under SAB Topic 11.M (SAB 74) and the SEC staff's expectation that those disclosures increase in explanation and specificity as the transition date approaches.

In late 2015, Deloitte administered a survey to gather information about the transition status of entities preparing for implementation of the new revenue standard. For a summary of the results of the survey, see Deloitte's January 14, 2016, *Heads Up*.

Chapter 16 — Nonpublic-Entity Requirements

During the final years of development of the new revenue standard, the FASB was under pressure from the AICPA and others regarding the establishment of U.S. GAAP for nonpublic entities. Specifically, some criticized the FASB for setting standards for large public companies that increase the complexity (and, therefore, the cost) associated with producing financial statements. As a result, the Financial Accounting Foundation, the FASB's parent organization, created the Private Company Council to help the FASB determine when there should be differences in U.S. GAAP for nonpublic entities (see Deloitte's May 25, 2012, journal entry and June 5, 2012, *Heads Up* for more information). Accordingly, throughout the redeliberations and final development of the new revenue standard, the FASB considered the disparate needs of users of nonpublic entities' financial statements. Ultimately, the FASB concluded that no specific recognition or measurement differences for nonpublic entities were necessary. However, the Board also concluded, largely on the basis of feedback from the nonpublic-entity community, that differences in the required disclosure package and mandatory effective date of the new revenue standard would be appropriate for nonpublic entities.

At the same time the FASB was developing the new revenue standard, it was working on a separate project to clarify which entities would be within the scope of the relief available to nonpublic entities under financial reporting standards. In that project, the Board decided to answer the question of which entities qualified for nonpublic-entity relief indirectly by determining in stages which entities would **not** qualify for such relief. The Board began its analysis by determining what constitutes a "public business entity." In ASU 2013-12, and as noted in Chapter 2, the Board defined the term as follows:

> A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.
>
> a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
>
> b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
>
> c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

In defining public business entities to exclude not-for-profit entities and employee benefit plans, the Board deferred to future deliberations on a standard-by-standard basis its determination of which, if any, not-for-profit entities and employee benefit plans would be eligible for relief available to nonpublic entities. Accordingly, the Board subsequently determined that an entity would be eligible for such relief under the new revenue standard if it **does not** meet the definition of any of the following:

- A public business entity.
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- An employee benefit plan that files or furnishes financial statements with or to the SEC.

After determining which entities could be afforded relief in application, the FASB considered the costs and benefits of making the requirements in the new revenue standard applicable to nonpublic entities and decided to provide those entities with relief related to:

- Disclosures.
- Mandatory effective date.

16.1 Disclosure Requirements

The Basis for Conclusions of ASU 2014-09 explains that one of the goals of ASC 606 is to improve the revenue disclosure guidance under U.S. GAAP. As a result of the disclosure requirements in ASC 606 (which are discussed in detail in Chapter 14), financial statement users will have better information to help them make financial decisions. However, when the FASB was developing the new standard, it received feedback from nonpublic companies related to (1) the increased costs that nonpublic entities would incur to meet the improved disclosure requirements and (2) questions about why nonpublic entities should be required to provide the same level of disclosure as public entities given that users of nonpublic-entity financial statements, typically debt holders, have greater access to management. The FASB considered the costs and benefits of its disclosure package and decided to provide various relief to nonpublic entities.

16.1.1 Disclosure Practical Expedients

The following table summarizes the practical expedients that nonpublic entities can elect for certain of the disclosures required by ASU 2014-09 (the ASU's disclosure requirements are covered in Chapter 14 as well as in the left-hand column below):

Disclosure Requirements	Practical Expedients for Nonpublic Entities
Present or disclose revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts. (ASC 606-10-50-4; see Section 14.2)	None.
A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the ASU also provides implementation guidance). (ASC 606-10-50-5 and 50-6; see Section 14.2.1)	An entity may elect not to provide the quantitative disclosure but should, at a minimum, provide revenue disaggregated according to the timing of transfer of goods or services (e.g., goods transferred at a point in time and services transferred over time). (ASC 606-10-50-7; see Section 14.2.1)
Information about (1) contract assets and contract liabilities (including changes in those balances) and the amount of revenue recognized in the current period that was previously recognized as a contract liability and (2) the amount of revenue recognized that is related to performance obligations satisfied in prior periods. (ASC 606-10-50-8 through 50-10; see Section 14.2.2)	An entity may elect not to provide the disclosures but should disclose the opening and closing balances of receivables, contract assets, and contract liabilities (if not separately presented or disclosed). (ASC 606-10-50-11; see Section 14.2.2)
Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions). (ASC 606-10-50-12; see Section 14.2.3)	None.
Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the remaining performance obligation" and when the entity expects to recognize that amount as revenue. (ASC 606-10-50-13 through 50-15; see Section 14.2.4)	An entity may elect not to provide these disclosures. (ASC 606-10-50-16; see Section 14.2.4)
A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations). (ASC 606-10-50-17 through 50-20; see Sections 14.3 through 14.3.2)	In accordance with ASC 606-10-50-21, an entity may elect not to provide any or all of the following disclosures: • An explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to the customer. • For performance obligations satisfied at a point in time, the significant judgments used in evaluating when a customer obtains control. • The methods, inputs, and assumptions used to determine the transaction price, except that an entity must disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained. (ASC 606-10-50-21; see Section 14.3.2)

(Table continued)

Disclosure Requirements	Practical Expedients for Nonpublic Entities
Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortization methods). (ASC 340-40-50-2 and 50-3; see Section 14.4)	An entity may elect not to provide these disclosures. (ASC 340-40-50-4; see Section 14.4)
Information about the entity's policy decisions (i.e., when the entity used the practical expedients allowed by the ASU). (ASC 606-10-50-22; see Sections 6.3.1 and 14.5)	An entity may elect not to provide these disclosures. (ASC 606-10-50-23; see Section 14.5)

Thinking It Through — Interim Reporting Requirements

Interim reporting requirements, including those related to disclosure, are outlined in ASC 270. In particular, public companies are required to disclose, at a minimum, the financial information required under ASC 270-10-50-1. Revenue disclosures are specifically addressed in ASC 270-10-50-1(a), which requires the disclosure of "[s]ales or gross revenues, provision for income taxes, net income, and comprehensive income." Section B of ASU 2014-09, Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables, expands this interim reporting requirement by adding the following guidance:

> **270-10-50-1A** Consistent with [ASC] 270-10-50-1, a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, shall disclose all of the following information about revenue from contracts with customers consistent with the guidance in [ASC] 606:
>
> a. A disaggregation of revenue for the period, see [ASC] 606-10-50-5 through 50-6 and [ASC] 606-10-55-89 through 55-91.
>
> b. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (if not otherwise separately presented or disclosed), see [ASC] 606-10-50-8(a).
>
> c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period, see [ASC] 606-10-50-8(b).
>
> d. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price), see [ASC] 606-10-50-8(c).
>
> e. Information about the entity's remaining performance obligations as of the end of the reporting period, see [ASC] 606-10-50-13 through 50-15.

Many nonpublic entities are not subject to interim financial reporting requirements and therefore would not be required to comply with the interim disclosure requirements in ASC 270. In addition, the same entities that are determined to be nonpublic for purposes of applying ASC 606 are outside the scope of the requirements in ASC 270-10-50-1A. As a result, even if a nonpublic entity produces interim financial information, it is not required to provide the disclosures outlined above that are required to be presented for public entities.

16.2 Effective Date

On August 12, 2015, the FASB issued ASU 2015-14, which delays the effective date of the new revenue standard by one year for all entities and permits early adoption on a limited basis. For nonpublic entities, the new revenue standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the new revenue standard as of any of the following:

- Annual reporting periods beginning after December 15, 2016, including interim periods.
- Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the annual reporting period in which the new revenue standard is initially applied.

Thinking It Through — The "One-Year" Delay

Effective-date relief to nonpublic entities is typically described as a one-year delay. However, the delay is likely to be even greater than one year because of the different adoption requirements for interim periods.

Public entities must adopt the new revenue standard for *annual* periods beginning after December 15, 2017 (one year earlier than nonpublic entities). However, public entities are also required to adopt the new guidance for *interim periods within* those annual periods. Therefore, a calendar-year-end public company will apply the new revenue standard when presenting its results for the first quarter of 2018 (i.e., the period ending March 31, 2018), which are likely to be issued in April 2018.

In contrast, nonpublic entities are not required to adopt the new revenue standard until they report their annual results. For example, a calendar-year-end nonpublic company would typically produce the results of its year ended December 31, 2019, in March or April 2020. In addition, if a nonpublic entity's financial statements for an interim period are required or are otherwise produced, the nonpublic entity is not required to adopt the new revenue standard for that interim period if it occurred in the year ended December 31, 2019. However, given that the annual results will be reported on a new basis (i.e., under ASC 606), a nonpublic entity may find it beneficial to early adopt the standard for interim periods since the entity would otherwise be required to revise the accounting for its revenue transactions as presented in its interim financial statements when including full-year results in its year-end reporting.

The following example illustrates how nonpublic entities would apply the new revenue standard's effective-date guidance:

Example 16-1

Companies X, Y, and Z are three independent companies. They all have calendar year-ends (i.e., December 31), as well as transactions within the scope of ASC 606. Each company has determined that it is a nonpublic entity (i.e., it does not meet the definition of a public business entity, and it does not constitute a not-for-profit entity or employee benefit plan as described above). All of the companies have outstanding debt with covenants that require them to provide their financiers with annual financial statements as of December 31 in accordance with U.S. GAAP. In addition, Y and Z are required to provide interim financial statements as of June 30.

Example 16-1 (continued)

Companies X and Y elect to adopt the new revenue standard as of the mandatory effective date; accordingly, each of these companies will be required to adopt the new revenue standard for the annual period that begins on January 1, 2019, and ends on December 31, 2019. In addition, Y is not required to adopt the new revenue standard as of June 30, 2019, and could instead continue to apply legacy U.S. GAAP (i.e., ASC 605 or other industry-specific GAAP) when it reports its interim financial information. However, Z determines that it would be easier to adopt the standard for interim periods within the annual period ended December 31, 2019.

In accordance with their election, both X and Y adopt the new revenue standard as of December 31, 2019, and they each report their financial statements under the new revenue standard in March 2020 for the full year ended December 31, 2019. Company Y presented its interim financial statements for June 30, 2019, by applying legacy U.S. GAAP (e.g., ASC 605); consequently, Y will revise the results of the period from January 1, 2019, to June 30, 2019, to reflect the change from ASC 605 to the guidance in ASU 2014-09, as amended, when it provides its full-year annual results (although the interim financial information previously issued under ASC 605 does not need to be reissued since it was compliant with U.S. GAAP). Company Z, in contrast to Y, elects to adopt the new standard when it reports its interim results (i.e., when Z produces its interim financial statements for June 30, 2019, it will present those results under the new guidance in ASU 2014-09, as amended). Consequently, Z will provide its results in August 2019 by using the new revenue standard, whereas X and Y will provide their results under the new guidance in March or April 2020. The following table summarizes these facts:

	Company		
Reporting Requirements	**X**	**Y**	**Z**
Fiscal year-end	December 31	December 31	December 31
Interim reporting	N/A	June 30	June 30
Fiscal year of adoption	Fiscal year 2019	Fiscal year 2019	Fiscal year 2019
Interim period of adoption	N/A	Fiscal year 2020	Fiscal year 2019

Depending on the facts and circumstances, including the needs of financial statement users, it might be beneficial for nonpublic companies to use an approach similar to that of Z, as outlined above. When using such an approach, a nonpublic company would not have to revise the financial information that was reported on an interim basis in its annual financial statements. In addition, it could be less time-consuming and more cost-efficient to early adopt ASC 606 for interim periods (e.g., as of June 30, 2019).

Chapter 17 — Sales of Nonfinancial Assets Within the Scope of ASC 610-20

17.1 Overview and Background

ASC 610-20

05-1 This Subtopic provides guidance on a gain or loss recognized upon the derecognition of a nonfinancial asset within the scope of Topic 350 on intangibles and Topic 360 on property, plant, and equipment (including in substance nonfinancial assets) if those assets are not in a contract with a customer within the scope of Topic 606 on revenue from contracts with customers.

ASU 2014-09 provides guidance on the recognition and measurement of transfers of nonfinancial assets, which is codified in ASC 610-20. The new revenue standard amends or supersedes the guidance in ASC 350 and ASC 360 on determining the gain or loss recognized upon the derecognition of nonfinancial assets, including in-substance nonfinancial assets, that are not an output of an entity's ordinary activities, such as sales of (1) property, plant, and equipment; (2) real estate; or (3) intangible assets. ASC 610-20 does not amend or supersede guidance that addresses how to determine the gain or loss on the derecognition of a subsidiary or a group of assets that meets the definition of a business. Gains or losses associated with these transactions will continue to be determined in accordance with ASC 810-10-40.

17.2 Scope of ASC 610-20

For a nonfinancial asset within the scope of ASC 350 or ASC 360, an entity would first determine whether the transfer of the nonfinancial asset is within the scope of ASC 606, ASC 610-20, or ASC 810. If the nonfinancial asset is an output of the entity's ordinary business activities (e.g., a home builder's sale of real estate), the arrangement would be accounted for under ASC 606. However, if the nonfinancial asset is *not* an output of the entity's ordinary business activities (e.g., a financial services company's sale of its headquarters), ASC 610-20 would apply.

An entity would continue to apply the derecognition guidance in ASC 810-10-40 when transfers or sales are not "in-substance nonfinancial assets" and the nonfinancial assets are held within a subsidiary or are a group of assets that meets the definition of a business. In addition, sale-and-leaseback transactions (e.g., real estate sale-and-leaseback transactions) would be accounted for under ASC 840-40 (or ASC 842-40). Further, ASC 610-20 does not apply to certain arrangements related to oil and gas mineral rights (i.e., those within the scope of ASC 932-360) or nonmonetary transactions (i.e., those within the scope of ASC 845-10).

ASC 610-20

15-2 The guidance in this Subtopic applies to the following events and transactions:

a. The gain or loss recognized upon the derecognition of a nonfinancial asset within the scope of Topic 350 on intangibles or Topic 360 on property, plant, and equipment, unless the entity sells or transfers the nonfinancial asset in a contract with a customer
b. The gain or loss recognized upon the transfer of financial assets that are in substance nonfinancial assets within the scope of Topic 350 or Topic 360 (for example, the sale of a subsidiary that only consists of an asset [for example, a machine or piece of equipment]).

Other Considerations

15-3 The guidance in this Subtopic does not apply to the following:

a. The derecognition of a nonfinancial asset, including an in substance nonfinancial asset, in a contract with a customer, see Topic 606 on revenue from contracts with customers
b. The derecognition of a subsidiary or group of assets that constitutes a business or nonprofit activity (excluding an in substance nonfinancial asset), see Section 810-10-40 on consolidation
c. Real estate sale-leaseback transactions, see Subtopic 360-20 and 840-40 on leases {Sale and leaseback transactions, see Subtopic 842-40 on leases}
d. A conveyance of oil and gas mineral rights, see Subtopic 932-360 on extractive activities
e. A transfer of a nonfinancial asset to another entity in exchange for a noncontrolling ownership interest in that entity, see the guidance on exchanges of a nonfinancial asset for a noncontrolling ownership interest in Section 845-10-30.

ASU 2014-09 does not define the term "in-substance nonfinancial assets," which is used to describe some types of transactions within the scope of ASC 610-20. The concept of an in-substance nonfinancial asset is that the economics of transferring a financial asset is substantially similar to that of transferring the underlying nonfinancial asset. For example, an entity may sell its equity interest in a legal entity that only holds an investment in real estate. In this situation, selling the underlying real estate is substantially similar to selling the equity interest (i.e., the financial asset). An entity will need to use judgment in determining whether the transfer of a subsidiary with nonfinancial assets (1) represents in-substance nonfinancial assets accounted for under ASC 610-20 or (2) should be accounted for as a deconsolidation under ASC 810.

Construction Ahead — FASB Proposal to Clarify Guidance on Derecognition of Nonfinancial Assets — Scope of ASC 610-20

On June 6, 2016, the FASB issued a proposed ASU that would clarify the scope of the Board's recently established guidance on nonfinancial asset derecognition (ASC 610-20) as well as the accounting for partial sales of nonfinancial assets. The proposals related to the accounting for partial sales of nonfinancial assets are further discussed in Section 17.3 below. The proposed ASU would conform the derecognition guidance on nonfinancial assets with the model for revenue transactions in ASC 606.

The proposed guidance is in response to stakeholder feedback indicating that (1) the meaning of the term "in-substance nonfinancial asset" is unclear because the Board's new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply.

Scope of the Guidance on Nonfinancial Asset Derecognition

The proposed ASU would clarify the scope of ASC 610-20 and require entities to apply that guidance to the derecognition of all nonfinancial assets and in-substance nonfinancial assets. While the concept of in-substance assets resided in ASC 360-20, this guidance would not have applied to transactions outside of real estate. The FASB is therefore proposing to add to the ASC master glossary the following definition of an in-substance nonfinancial asset:

> An asset of a reporting entity that is included in either of the following:
>
> a. A contract in which substantially all the fair value of the assets (recognized and unrecognized) promised to a counterparty is concentrated in nonfinancial assets
>
> b. A consolidated subsidiary in which substantially all the fair value of the assets (recognized and unrecognized) in the subsidiary is concentrated in nonfinancial assets.
>
> An in substance nonfinancial asset does not include:
>
> a. A group of assets or a subsidiary that is a business or nonprofit activity
>
> b. An investment of a reporting entity that is being accounted for within the scope of Topic 320 on investments — debt securities, Topic 321 on investments — equity securities, Topic 323 on investments — equity method and joint ventures, or Topic 325 on other investments regardless of whether the assets underlying the investment would be considered in substance nonfinancial assets.

Accordingly, since business or nonprofit activities are not in-substance nonfinancial assets, they would be excluded from the scope of ASC 610-20 and accounted for under the consolidation guidance in ASC 810-10. Further, all investments would be accounted for under the guidance in ASC 860 on transfers and servicing transactions, regardless of whether the investment was a business or nonprofit activity or an in-substance nonfinancial asset.

The clarification that a business activity would not be considered an in-substance nonfinancial asset is based on another proposed ASU that would clarify and narrow the definition of a business and most likely reduce the number of real estate transactions that would be considered businesses. The comment period on that proposal ended in January 2016, and on the basis of feedback, the FASB may need to reconsider whether ASC 610-20 should be applied to certain types of businesses.

The proposed ASU on nonfinancial assets would also clarify that if a transaction that does not involve a subsidiary is partially within the scope of ASC 610-20 and partially within the scope of other guidance, an entity would apply the separation and allocation guidance in ASC 606 to determine how to separate and measure certain parts of the transaction. A transaction involving a subsidiary that does not have in-substance nonfinancial assets would be excluded from the scope of ASC 610-20 in its entirety.

Unit of Account

For derecognition purposes, the proposed ASU would clarify the unit of account, which is defined as a distinct nonfinancial asset. The entity would, at the inception of the contract, identify the nonfinancial and in-substance nonfinancial assets and would, in accordance with the guidance on identifying distinct performance obligations in ASC 606 (see Chapter 5), identify the *distinct* nonfinancial assets. The entity would then allocate the consideration to each distinct nonfinancial asset, consistent with the approach outlined in ASC 606 (see Chapter 7).

Additional Standard-Setting Activities

Stay tuned for future developments on these topics, including future FASB meetings before the finalization of these proposals.

17.3 Gain or Loss Recognition for Nonfinancial Assets

ASC 610-20

40-1 To determine when a nonfinancial asset shall be derecognized, an entity shall apply the following paragraphs in Topic 606 on revenue from contracts with customers:

a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract
b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

ASC 610-20

32-1 To determine the amount of consideration to be included in the calculation of a gain or loss recognized upon the derecognition of a nonfinancial asset, an entity shall apply the following paragraphs in Topic 606 on revenue from contracts with customers:

a. Paragraphs 606-10-32-2 through 32-27 on determining the transaction price, including all of the following:
   1. Estimating variable consideration
   2. Constraining estimates of variable consideration
   3. The existence of a significant financing component
   4. Noncash consideration
   5. Consideration payable to a customer.
b. Paragraphs 606-10-32-42 through 32-45 on accounting for changes in the transaction price.

ASC 610-20

40-2 When the guidance in paragraph 610-20-40-1 is met, an entity shall derecognize the nonfinancial asset and recognize as a gain or loss the difference between the amount of consideration measured in accordance with paragraph 610-20-32-1 and the carrying amount of the nonfinancial asset. When the guidance in paragraph 610-20-40-1 is not met, an entity shall apply the guidance in paragraphs 350-10-40-3 to intangible assets and 360-10-40-3C to property, plant, and equipment.

ASC 610-20 applies many of the same principles as ASC 606 for determining the gain or loss to recognize when a nonfinancial asset is derecognized. Specifically, ASC 610-20 incorporates the requirements to determine (1) when a contract exists (i.e., step 1); (2) the amount of consideration to be included in the determination of the gain or loss recognized, including an estimate of variable consideration and the application of the "constraint" (i.e., step 3); and (3) when control of the nonfinancial asset is obtained and results in the recognition of gain or loss (i.e., step 5). In a manner similar to the accounting for a contract with a customer, an entity would apply the guidance in ASC 606-10-25-6 through 25-8 if an arrangement fails to meet the criteria in ASC 606-10-25-1 for determining the existence of a contract (see Sections 4.4 and 4.5). In this situation, the nonfinancial asset would be (1) recognized in the statement of financial position, (2) amortized through its useful life (except for indefinite-lived intangible assets and property, plant, and equipment classified as held for sale), and (3) assessed for impairment.

Certain transactions of nonfinancial assets may also include goods or services or other elements that are not within the scope of ASC 610-20 (or ASC 606). In these situations, an entity would apply the guidance in ASC 606-10-15-4 in determining the separation and measurement of the good or service in the contract. Any aspect of the contract that is initially measured and recognized under separate U.S. GAAP requirements would not be accounted for under ASC 610-20.

Construction Ahead — FASB's Proposal to Clarify Guidance on Derecognition of Nonfinancial Assets — Partial Sales

On June 6, 2016, the FASB issued a proposed ASU that would clarify the scope of the Board's recently established guidance on nonfinancial asset derecognition (ASC 610-20) as well as the accounting for partial sales of nonfinancial assets. The proposals related to the scope of the nonfinancial asset derecognition guidance in ASC 610-20 are further discussed in Section 17.2 above.

"Partial sales" are sales or transfers of a nonfinancial asset to another entity in exchange for a noncontrolling ownership interest in that entity. Such sales are common in the real estate industry (e.g., a seller transfers an asset to a buyer but either retains an interest in the asset or has an interest in the buyer). Entities account for partial sales before adoption of the new revenue standard principally under the transaction-specific guidance in ASC 360-20 on real estate sales and partly under ASC 845-10-30. The proposed ASU would supersede that guidance and clarify that any transfer of a nonfinancial asset in exchange for the noncontrolling ownership interest in another entity (including a noncontrolling ownership interest in a joint venture or other equity method investment) would be accounted for in accordance with ASC 610-20.

In addition, if the reporting entity no longer retained a controlling financial interest in the nonfinancial asset, it would derecognize the asset when it transferred control of that asset in a manner consistent with the principles in ASC 606. Further, any retained noncontrolling ownership interest (and resulting gain or loss to be recognized) would be measured at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-20-32-21 through 32-24 (see Section 6.4).

However, if the entity retained a controlling financial interest in a subsidiary (i.e., when the entity sold a noncontrolling ownership interest in a consolidated subsidiary), the entity would account for the transaction as an equity transaction in accordance with ASC 810 and would not recognize a gain or loss on the derecognition of nonfinancial assets. Only when the entity no longer had a controlling financial interest in a former subsidiary, and transferred control of the nonfinancial asset in accordance with ASC 606, would the entity apply the derecognition guidance in ASC 610-20.

The proposed ASU would thus eliminate the initial measurement guidance on nonmonetary transactions in ASC 845-10-30 (in a manner consistent with the FASB's deletion of the guidance in ASC 360-20) to simplify the accounting treatment for partial sales (i.e., entities would use the same guidance to account for similar transactions) and to remove inconsistencies between ASC 610-20 and the noncash consideration guidance in the new revenue standard.

The Q&A below illustrates how an entity would calculate and recognize a gain or loss on the sale of a nonfinancial asset within the scope of ASC 610-20 that involves a guarantee.

Q&A 17-1 Accounting for the Sale of a Nonfinancial Asset Within the Scope of ASC 610-20 With a Guarantee

Question

How should a seller account for a contract under which it promises to sell property and to guarantee the buyer's return on the property?

Answer

The seller must first identify all of the elements in the contract to determine whether the contract is (1) within the scope of ASC 610-20, (2) within the scope of other topics, or (3) partially within the scope of both ASC 610-20 and other topics. A contract to sell property to a counterparty that includes a guarantee of the buyer's return on the property contains both a performance obligation within the scope of ASC 610-20 and a guarantee within the scope of ASC 460-10.

ASC 606-10-15-4(a) states, in part:

> If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics.

Accordingly, the seller would initially measure the guarantee at fair value as required under ASC 460-10. The difference between the transaction price and the guarantee's fair value would be allocated to the identified performance obligation(s) — which may include other goods or services in addition to the property being sold — and any gain or loss would be recognized when (or as) control of each performance obligation is transferred to the buyer.

However, if the seller determines that the contract (which includes the guarantee) will result in a loss, it should evaluate whether an impairment has occurred under relevant impairment guidance (e.g., ASC 330 on inventory, ASC 350 on intangibles, or ASC 360 on property, plant, and equipment).

Example 1

Company X sells an office building with a cost basis of $40,000 to Company Y for $100,000. As part of the sales contract, X guarantees that it will make payments of up to $40,000 each year for two years based on the proportion of the building that remains unleased at the end of each year. Since X expects all space to be rented within two months, it has determined that its guarantee to Y has a fair value of $15,000.

Company X should separate and initially measure the guarantee in accordance with ASC 460-10 and then deduct the fair value of the guarantee ($15,000) from the transaction price of $100,000. After allocating the remaining $85,000 to the sole performance obligation (i.e., the sale of the building), X would recognize a $45,000 gain ($85,000 allocated to the building less X's cost basis of $40,000) upon transferring control of the building to Y.

Example 2

Assume the same facts as in Example 1, except that Company X (1) determines on the basis of the current rental market that the space will not be leased for the foreseeable future and (2) calculates that the fair value of the guarantee is $70,000.

Company X should separate and initially measure the guarantee in accordance with ASC 460-10 and then deduct the fair value of the guarantee ($70,000) from the transaction price of $100,000. The company would allocate the remaining $30,000 to the performance obligation of transferring the building. Since this allocation is less than the building's book value, X would assess the building on the basis of the impairment requirements in ASC 360 and conclude that the building's carrying amount is not recoverable. Therefore, X would immediately record an impairment loss of $10,000 (measured as the excess of the building's carrying value of $40,000 over its fair value of $30,000).

The following example in ASC 610-20 illustrates how an entity would account for a sale of a nonfinancial asset in exchange for variable consideration:

ASC 610-20

55-2 An entity sells the rights to in-process research and development that it recently acquired in a business combination and measured at fair value of $50 million in accordance with Topic 805 on business combinations. The buyer of the in-process research and development agrees to pay a nonrefundable amount of $5 million at inception plus 2 percent of sales of any products derived from the in-process research and development over the next 20 years. The entity concludes that the sale of in-process research and development is not a good or service that is an output of the entity's ordinary activities.

ASC 610-20 (continued)

55-3 Topic 350 on goodwill and other intangibles requires the entity to apply the guidance on existence of a contract, control, and measurement in Topic 606 on revenue from contracts with customers to determine the amount and timing of income to be recognized as follows:

a. The entity concludes that the criteria for identifying a contract in paragraph 606-10-25-1 are met.
b. The entity also concludes that on the basis of the guidance in paragraph 606-10-25-30, it has transferred control of the in-process research and development asset to the buyer as of contract inception. This is because as of contract inception the buyer can use the in-process research and development's records, patents, and supporting documentation to develop potential products and the entity has relinquished all substantive rights to the in-process research and development asset.
c. In estimating the consideration received, the entity applies the guidance in Topic 606 on determining the transaction price, including estimating and constraining variable consideration. The entity estimates that the amount of consideration that it will receive from the sales-based royalty is $100 million over the 20-year royalty period. However, the entity cannot assert that it is probable that recognizing all of the estimated variable consideration in other income would not result in a significant reversal of that consideration. The entity reaches this conclusion on the basis of its assessment of factors in paragraph 606-10-32-12. In particular, the entity is aware that the variable consideration is highly susceptible to the actions and judgments of third parties, because it is based on the buyer completing the in-process research and development asset, obtaining regulatory approval for the output of the in-process research and development asset, and marketing and selling the output. For the same reasons, the entity also concludes that it could not include any amount, even a minimum amount, in the estimate of the consideration. Consequently, the entity concludes that the estimate of the consideration to be used in the calculation of the gain or loss upon the derecognition of the in-process research and development asset is limited to the $5 million fixed upfront payment.

55-4 At inception of the contract, the entity recognizes a net loss of $45 million ($5 million of consideration, less the in-process research and development asset of $50 million). The entity reassesses the transaction price at each reporting period to determine whether it is probable that a significant reversal would not occur from recognizing the estimate as other income and, if so, recognizes that amount as other income in accordance with paragraphs 606-10-32-14 and 606-10-32-42 through 32-45.

17.4 Considerations Related to Real Estate Sales

ASU 2014-09 replaces all of the real estate sales guidance in ASC 360-20 (formerly FAS 66). However, the guidance on real estate sales that are part of a sale-and-leaseback transaction accounted for under ASC 840-40 will remain until ASU 2016-02 (ASC 842) is effective. Specifically, ASU 2014-09 eliminates the requirements in ASC 360-20 for assessing (1) the adequacy of a buyer's initial and continuing investments and (2) the seller's continuing involvement with the property. Under the new revenue standard, entities need to critically evaluate whether (1) it is "probable" that they will collect the consideration to which they will be entitled in exchange for transferring the real estate and (2) a seller's postsale involvement should be accounted for as a separate performance obligation.

17.4.1 Scope of Real Estate Sales

The new revenue standard retains the current guidance in ASC 970 requiring an investor to generally record its contribution of real estate to a real estate joint venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed regardless of whether the other investors contribute cash, property, or services. However, if the transaction is an in-substance sale, it would be accounted for in accordance with ASC 610-20 on the derecognition of nonfinancial assets.

For example, suppose that two investors, Investor A and Investor B, form a real estate venture. Investor A contributes cash in exchange for a 50 percent interest in the venture; B contributes real estate in exchange for the other 50 percent of the venture and receives the cash contribution made by A. If B is not committed to reinvest the cash received from the venture, the substance of the transaction is a sale of a one-half interest in the real estate in exchange for cash. In this situation, an entity would apply the derecognition guidance to determine the gain or loss to be recognized.

However, ASU 2014-09 does not provide guidance on the accounting for partial sales (e.g., selling a one-half interest in real estate). Consequently, after issuing the ASU, the FASB added to its agenda a project on clarifying the scope of the derecognition guidance in ASC 610-20 and on the accounting for partial sales of nonfinancial assets. As noted in Sections 17.2 and 17.3 above, that project resulted in a proposed ASU that addresses the accounting for partial sales of nonfinancial assets, including in-substance nonfinancial assets. If finalized as proposed (see Construction Ahead in Section 17.3), it would change the outcome in the above example.

Entities may also enter into like-kind exchanges in which real estate owned by one entity is exchanged for real estate owned by another entity. These types of transactions are typically structured for tax purposes. Under the new revenue standard, a nonmonetary exchange of real estate is accounted for as a sale of the real estate asset for noncash consideration (i.e., the real estate received from another entity). Accordingly, if the transaction meets the criteria to be accounted for as a sale (i.e., the existence of a contract and the transfer of control of the real estate), the entity would measure the noncash consideration received in the transaction at fair value.[1] The entity would recognize a gain or loss on the sale and record the acquired nonmonetary consideration (i.e., the real estate received) at its fair value. However, the entity would continue to apply the current guidance on nonmonetary exchanges in ASC 845 if (1) it receives a noncontrolling ownership interest in the purchaser entity in exchange for the real estate asset or (2) the exchange is between entities in the same line of business to help facilitate sales to potential customers.

Construction Ahead — Proposal to Eliminate Guidance on Nonfinancial Assets Exchanged for a Noncontrolling Interest

As noted in Section 17.3 above, the FASB has proposed to eliminate the guidance in ASC 845 on exchanges of nonfinancial assets for a noncontrolling interest. Under the Board's proposal, the noncontrolling interest received in connection with the partial sale would be measured at fair value and included in the transaction price. An entity would then need to determine whether control of the real estate is transferred when (or as) the performance obligation is satisfied.

17.4.1.1 Sale-and-Leaseback Transactions

Entities may structure a transaction in which an owner of real estate sells the asset and then leases it back from the buyer (a "sale-and-leaseback transaction"). Under current U.S. GAAP, the sale-and-leaseback guidance in ASC 840-40 applies to a transaction involving real estate only if the transaction:

- Includes a "normal leaseback" under ASC 840-40.
- Includes "payment terms and provisions [that] adequately demonstrate the buyer-lessor's initial and continuing investment in the property."
- "[T]ransfer[s] all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee."

[1] As noted in Chapter 6, ASU 2016-12 clarifies that the measurement date for noncash consideration is the contract inception date.

If any of these three criteria are not met, the transaction is accounted for as a financing arrangement.

ASU 2014-09 generally supersedes the real estate sales guidance in ASC 360-20. However, the FASB decided that if a sale of real estate (including, for example, property improvements) is part of a sale-and-leaseback transaction, the transaction would be evaluated under ASC 840-40 (or ASC 842-40).

17.4.2 Identifying the Contract

Under current guidance on the sale of real estate with seller financing, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

The specified investment requirement is eliminated under ASU 2014-09. However, as noted in Section 17.3 above, the contract existence criteria need to be met before a sale can be recorded in accordance with ASC 610-20 (see Chapter 4). Collectibility of substantially all of the consideration to which the entity expects to be entitled affects the evaluation of whether a contract exists for accounting purposes. Upon a determination that it is not probable that the entity will collect substantially all of the consideration to which it will be entitled (i.e., a determination that the collectibility threshold is not met), no contract is deemed to exist and no sale can be recorded. However, the new revenue standard does not include specific initial and continuing investment thresholds for performing this evaluation.

The collectibility criterion should be evaluated on the basis of the amount to which the entity expects to be entitled, which may not be the stated transaction price. For example, these two amounts may differ because an entity anticipates offering the customer a price concession. Accordingly, entities should carefully assess the facts and circumstances to determine whether, on the basis of their assessment of the customer's credit risk (for example), they expect to grant a price concession.

If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under ASC 606-10-25-1. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would determine the transaction price and evaluate the arrangement under the derecognition criteria in the new revenue standard. If, instead, the contract is terminated, the seller would recognize any nonrefundable deposits received as a gain.

ASC 606 contains an example of a real estate sale (see Section 4.5) in which the buyer pays a 5 percent nonrefundable deposit for the property and the seller finances the remaining purchase price. The buyer's ability to pay the outstanding purchase price is contingent solely on its ability to generate profits from the use of the real estate. In the original example in ASU 2014-09, on the basis of the facts and circumstances, the seller concludes that the collectibility threshold in ASC 606-10-25-1 is not met because the buyer's intent and ability to pay the outstanding amount are in doubt. In the example (as modified by ASU 2016-12), control of the building does not transfer to the buyer. Entities will need to use considerable judgment when evaluating the criteria for determining (1) whether a contract exists and (2) whether and, if so, when control is transferred for accounting purposes.

The collectibility guidance in step 1 of the new revenue standard is further discussed in Section 4.2.5.

17.4.3 Identifying the Performance Obligations

Sometimes, a seller remains involved with property that has been sold. Under current guidance, profit is generally deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under the new revenue standard, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a separate performance obligation, constitutes a guarantee, or prevents the transfer of control. If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized when (or as) the entity transfers the related good or service to the customer.

To be considered a separate performance obligation, a good or service needs to be distinct. A good or service is considered distinct (and therefore a separate performance obligation) if it is both (1) capable of being distinct and (2) distinct in the context of the contract (see Chapter 5 for additional information about identifying performance obligations).

For example, assume that as part of a sale of land, the seller agrees to erect a building on the land in accordance with agreed-upon specifications. If the sale of land and the construction of the building are considered separate performance obligations, the seller would be required to recognize an allocated portion of the total transaction price as each good or service is transferred to the customer. However, if the sale of land and the construction of the building are not considered separate performance obligations, the consideration received in connection with the sale of the land would be included in the transaction price attributed to the performance obligation (i.e., the combined obligation to transfer the land and construct the building). The transaction price would be recognized when (or as) the combined performance obligation is satisfied.

Driving Discussion — Implementation Concerns

Implementation concerns have been raised by various stakeholders in the real estate industry, including real estate developers and construction and engineering entities.

Real estate developers have questioned the accounting for contracts for which it is expected that certain amenities or common areas will be provided in a community development (to be owned by either a homeowners association or the local municipality). Specifically, they have asked whether these common areas and other amenities should be accounted for as separate performance obligations. We believe that a developer that intends to provide common areas (e.g., a community center, parks, tennis courts) to a homeowners association as part of a development would generally not consider such an arrangement to represent a promise to deliver goods or services in the separate contracts to sell real estate (e.g., a single-family home) to its other customers. That is, the agreement with the homeowners association would not be combined with an agreement to sell real estate to a separate customer. Further, we believe that control of the common areas will not be transferred to the community homeowners but will be transferred to the homeowners association instead. Consequently, the expected construction of the common areas would not represent a performance obligation of the developer. Note that the new revenue standard does not amend the guidance in ASC 970 that requires a developer to use a cost accrual approach upon sale of the real estate to account for costs of the common areas.

Construction and engineering entities often include deliverables that are completed over a number of phases. Such phases often include engineering, design, procurement, and construction of a facility or project. Stakeholders have raised questions and have had differing views about whether phases of a project (e.g., in typical design-and-build contracts) are distinct performance obligations or part of one combined performance obligation because they may not be distinct in the context of the contract. Under the new revenue standard, it may be difficult to assess whether phases of engineering, design, procurement, and construction are part of one combined performance obligation (e.g., because the phases are highly dependent and highly interrelated or part of a significant service of integration) or are distinct performance obligations. Such difficulty may also affect the way other gains or losses (or revenue, if the transaction is with a customer) are recognized (e.g., (1) at a point in time or over time and (2) the measure of progress if revenue is recognized over time). Accordingly, entities will need to exercise significant judgment and consider the specific facts and circumstances of each contract. Entities are also encouraged to keep abreast of the FASB's standard-setting activities.

Given that the accounting could vary significantly depending on whether an arrangement involves multiple distinct performance obligations, entities should carefully analyze their sales contracts to determine whether any promises of goods or services represent distinct performance obligations.

17.4.4 Determining the Transaction Price and Allocating It to the Performance Obligations

A sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event (i.e., the price is no longer variable). Any additional revenue would be recorded only when the contingency is resolved. Under ASU 2014-09, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (see Chapter 6).

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price, which may be recognized when the performance obligation is satisfied. As a result, the revenue may sometimes be recognized earlier under the new revenue standard than under current U.S. GAAP.

For example, suppose that Company A sells land to a home builder for a fixed amount plus a percentage of the profits that will be realized on the sale of homes once constructed on the land by the home builder. Under current U.S. GAAP, participation in the profit would be delayed until the homes are sold, profits are realized, and A is under no obligation to refund any amounts received to date. Under the new revenue standard, A would be required to (1) estimate the consideration expected to be received from the home builder and (2) recognize all or some of the amount as other gains and losses (or revenue, if the transaction is with a customer) up front when the land is sold. Determining the amount of other gains or losses that is not subject to a significant revenue reversal could require significant judgment.

Further, the new revenue standard requires entities to adjust the promised consideration in a contract for the time value of money when the arrangement provides either the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer (see Section 6.3). In such instances, the entity will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the customer had paid cash for the promised goods or services at the time control was transferred to the customer. In calculating the amount of consideration attributable to the significant financing component, the entity should use an interest rate that reflects a hypothetical financing-only transaction between the entity and the customer. As a practical expedient, ASU 2014-09 does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between transfer of the promised goods and services and the payment of the associated consideration is one year or less.

In addition, the contract would not have a financing component if the difference between the amount of consideration the customer would have paid at the time of transfer of the promised goods or services and the amount of consideration actually paid as the goods or services are transferred arises for reasons other than financing. For example, a customer may be entitled to withhold payment of 10 percent of total promised consideration throughout a development project to ensure that construction or development is completed in accordance with the terms of the contract. In this situation, even though the amount of consideration the entity receives might differ from the value of the goods transferred to the customer over the contract term, the difference arises for reasons other than financing. That is, the difference is to provide the customer protection against unsatisfactory completion of the contract. Consequently, in a manner consistent with the discussion in paragraph BC233(c) of ASU 2014-09, the entity would conclude that there is no financing component in the arrangement.

If an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the buyer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the buyer or the seller a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the seller or the buyer).

17.4.5 Determining When an Entity Satisfies Its Performance Obligation

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer. Under the new revenue standard, a seller of a nonfinancial asset (e.g., real estate) would evaluate whether a performance obligation is satisfied (and the related gain or loss recognized) when control of the underlying assets is transferred to the purchaser. An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred to the customer (see Section 8.4 for a discussion of the requirements for recognizing revenue over time).

Thinking It Through — Revenue Over Time

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. The new revenue standard contains an example (see Section 8.4.3.2) in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete.

Substantially all sales of nonfinancial assets (that are not contracts with customers) will be recorded at a point in time. If control is transferred at a point in time, a gain or loss is recognized when the good or service is transferred to the customer. (See Section 8.6 for a discussion of the requirements for recognizing revenue at a point in time.) Under the new revenue standard, entities determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP. However, the FASB decided to include in ASC 606-10-25-30 "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has been transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under ASU 2014-09.

Q&A 17-2 Evaluating Whether Control Has Been Transferred in a Sale of Real Estate Without a Formal Closing

Question

Could control of real estate be transferred without a formal closing?

Answer

In certain limited cases, control of real estate could be transferred to a customer even though a formal closing has not occurred. For example, if the escrow holder or trustee has received all consideration for the sale as well as the title to the property from the seller but the formal closing process has not been completed, the seller may record a sale as of the time the title was transferred if it has evaluated the indicators in ASC 610-20-40-1 and has determined that (1) collectibility is probable, (2) it transferred control of the real estate to the buyer, and (3) it satisfied its performance obligations under the contract.

On the other hand, the lack of a formal closing (e.g., because of unresolved contingencies) may indicate that the seller has not fulfilled its performance obligations under the contract and therefore has not transferred control of the real estate.

Sometimes a sale of real estate will be structured so that title does not pass to the buyer until part or all of the consideration is received by the seller without recourse. For example, if the sale is structured as a "contract for deed," title may not be transferred until the buyer's obligation to the seller is paid in full. Generally, a seller may structure a sale as a contract for deed because of concern that the full sales price will not be collected. Any recognition of gains or losses would be inappropriate in this case because collectibility is not probable and legal title has not transferred to the buyer.

17.4.6 Real Estate Sales With a Repurchase Agreement

If the seller has an obligation or option to repurchase a property it has sold (a forward or call option), it should account for the sale as (1) a lease if the repurchase amount is less than the original selling price or (2) a financing arrangement if the repurchase price is more than the original selling price.

If the buyer has an option to require the seller to repurchase the property (a put option), the seller would determine whether to account for the transaction as a lease, a sale with a right of return, or a financing arrangement by performing the following analysis:

- If the repurchase price under the option is lower than the original selling price, the seller would need to consider at contract inception whether the buyer has a significant economic incentive to exercise its option. If the buyer has such an incentive, the contract should be treated as a lease (unless the transaction involves a leaseback and would result in a lease-leaseback transaction, in which case the entire transaction should be treated as a financing). Otherwise, the transaction should be accounted for as a sale with a right of return.
- If the repurchase price under the option is equal to or greater than the original selling price, the seller should treat the contract as a financing arrangement unless the expected fair value of the asset is greater than the repurchase price and the buyer does not have a significant economic incentive to exercise the option, in which case the transaction should be accounted for as a sale with a right of return.

If the seller of real estate is required to treat a transaction as a financing arrangement, it would continue to recognize the property (and associated depreciation) and record a liability for the consideration received from the buyer. The difference between the amount of consideration received from the buyer and the amount paid under the repurchase agreement should be recorded as interest over the term of the arrangement. If the seller is required to treat the transaction as a lease, it would account for the arrangement in accordance with ASC 840 (or ASC 842).

See Section 8.7 for further discussion of repurchase agreements and their impact on transferring control.

Chapter 18 — Tax Considerations

The Internal Revenue Code (IRC) and federal income tax regulations contain rules for recognizing revenue in general and on certain types of transactions (e.g., long-term contracts, arrangements involving advance payments for goods or services, and licenses of intangible property). To the extent that the tax rules are similar to the rules and methods a taxpayer uses for financial accounting purposes, the taxpayer often employs the same revenue recognition method for both books and tax. Although the IRC does not require taxpayers to use any particular underlying financial accounting method to determine taxable income, they must make appropriate adjustments (on Schedule M of the tax return) to their financial accounting pretax income to determine taxable income if a different method is used or required. Because the starting point for computing taxable income begins with a taxpayer's financial accounting income, changes in the timing of revenue recognition and, in some cases, the amount of revenue recognized under the new revenue standard may also affect taxable income. Entities should also evaluate additional tax impacts such as financial reporting for income taxes, indirect taxes, foreign jurisdictions, and, potentially, transfer pricing.

18.1 General U.S. Federal Income Tax Principles for Revenue Recognition

Under general U.S. federal income tax principles, an accrual-basis taxpayer reports income in the taxable year in which (1) the right to the revenue becomes fixed (the "first criterion") and (2) the amount can be determined with reasonable accuracy (the "second criterion").

Under the first criterion, an amount is considered fixed at the earliest of when (1) payment is made, (2) payment is due, or (3) performance has occurred. Performance occurs (1) when all of the services are provided, (2) when the sale of goods or other property takes place, or (3) over the period in which the property is used. Minor or ministerial acts that remain to be performed (e.g., the sending of a bill), will not defer the recognition of income that is otherwise earned.

Under the second criterion, an amount can be determined with reasonable accuracy when an approximate amount is reasonably ascertainable. However, a taxpayer should not recognize income if its customer disputes the amounts to be paid.

For performance of services, income is generally recognized as the services are provided. However, income is not recognized upon the taxpayer's "partial performance" of services unless the services are "severable" under the terms of the contract.

Income from the sale of goods (or other property, such as real estate) is recognized for the taxable year in which the sale takes place. A sale of goods or other property occurs in the taxable year in which the benefits and burdens of ownership are transferred from the seller to the buyer. Benefits and burdens of ownership may be transferred when (1) the goods are shipped, (2) the product is delivered or accepted, or (3) title to the goods passes to the customers in accordance with the sales agreement.

With respect to income from the license of intangible property, revenue generally is recognized over the period in which the licensed property is used.

The U.S. federal income tax laws also include specific rules related to the recognition of revenue for certain types of transactions that may create differences between book and tax methods. For example, taxpayers are permitted to defer advance payments received for the sale of goods, provision of services, and licensing of certain intellectual property (IP) in limited circumstances. The sections below highlight both general and specific revenue recognition rules.

18.2 Step 1 — Identify the Contract With the Customer

In step 1 of the new revenue model (i.e., identify the contract with the customer), the new revenue standard stipulates that among the criteria that must be met for an entity to identify a contract with a customer, it must be probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. (See Chapter 4 for further discussion of the step 1 criteria and this specific collectibility threshold.) If a contract does not meet this criterion and the other four step 1 criteria at contract inception, the entity will not recognize revenue until amounts received are nonrefundable and one of the following criteria is met:

1. There are no remaining obligations to transfer goods or services, and substantially all of the consideration has been received.
2. The contract is terminated or canceled.
3. The entity has transferred control of the goods or services to which the consideration is related, has stopped transferring goods or services, and has no obligation to transfer additional goods or services.

If none of the events described in (1), (2), and (3) occur, any consideration received would be recognized as a liability until the step 1 criteria are met.

Under U.S. federal income tax principles, a taxpayer is not required to meet a “probable” collectibility threshold before recognizing revenue. Generally, revenue is recognized for tax purposes when both of the following criteria are met:

- The taxpayer’s right to the revenue becomes fixed (i.e., upon the occurrence of all of the events on which the taxpayer’s right to the income was contingent).
- The amount can be determined with reasonable accuracy.

For a taxpayer not to recognize revenue under the general U.S. federal income tax rules, the taxpayer bears the burden of proof that there is reasonable doubt and uncertainty regarding the collectibility of the income at the time the taxpayer has the right to receive the income or by the end of the taxpayer’s tax year. This “doubtful” collectibility exception is narrowly applied for tax purposes and may be different from the “probable” collectibility threshold under the ASU. When a contract does not meet the “probable” collectibility threshold for book purposes, revenue may continue to be recognized for tax purposes depending on the particular facts and circumstances.

18.2.1 Reassessing the Criteria for Identifying a Contract (Example 4 in ASC 606-10-55-106 Through 55-109) — Tax Implications

In Example 4 of ASC 606 (reproduced in Section 4.4), an entity licenses a patent to a customer in exchange for a usage-based royalty, but the customer’s ability to pay later deteriorates significantly. As a result of the significant deterioration in the customer’s ability to pay, the entity does not recognize additional revenue associated with the customer’s future use of the entity’s patent under the new revenue standard.

From a tax perspective, however, the entity must also analyze the customer’s financial conditions under the “doubtful” collectibility standard to determine whether it is necessary to continue recognizing revenue for tax purposes if the customer continues to use the entity’s patent.

18.3 Step 2 — Identify the Performance Obligations

In step 2 of the new revenue model (i.e., identify the performance obligations), an entity is required to identify as a performance obligation each promise to transfer (1) a distinct good or service (or a distinct bundle of goods or services) or (2) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. How a good or service is bundled with another good or service when the separate performance obligations are identified may result in a change in timing of the revenue recognized under the U.S. federal income tax rules. In addition, any change in the characterization of an item on the balance sheet from an asset to a liability (or vice versa) may require an entity that previously recognized the item under the tax revenue recognition principles to change its method of accounting to (or from) the “liability as incurred” standard.

Further, the U.S. federal income tax laws generally require a taxpayer to identify deliverables on the basis of the form of the contract. In multiple-element contracts, the number of deliverables for tax purposes may be different from the number of performance obligations for book purposes. When identifying deliverables, practitioners will need to evaluate the potential for increased transactional taxes (or the ability to maintain current billing systems).

18.3.1 Warranties (Example 44 in ASC 606-10-55-309 Through 55-315) — Tax Implications

Whether a warranty is identified as a performance obligation separate from a product or as a single obligation bundled with the sale of a product may create a difference in treatment of the item for U.S. federal income tax purposes.

In Example 44 of ASC 606 (reproduced in Section 5.5.5), an entity enters into a contract with a customer to provide (1) a product and (2) training services on how to operate the product. The contract includes a warranty that provides assurance to the customer that the product will function as intended for one year. Although the entity accounts for the product and training services as two separate performance obligations, it does not account for the warranty as a separate performance obligation because it concludes that the warranty does not provide the customer with a good or service in addition to the assurance (i.e., it concludes that the warranty is not a service-type warranty).

However, if the entity's contract were to include an extended warranty that provides services or assurance beyond the standard one-year assurance warranty, the entity would need to allocate the transaction price among the three performance obligations identified in the contract (i.e., the product, the training, and the extended warranty) on the basis of their relative stand-alone selling prices. Under both current U.S. GAAP and the ASU, there would be a deferral of revenue for the extended warranty until the obligation is satisfied.

Under the U.S. federal income tax laws, if a taxpayer receives advance payments for the future sale of goods or provision of services, the taxpayer is permitted to apply the financial reporting deferral for the advance payment in the taxable year of receipt and recognize the remaining amount of the advance payment in the next succeeding taxable year. If the transaction price allocated to the extended warranty under the ASU is greater than the extended warranty price determined under current U.S. GAAP, the additional deferred revenue related to the extended warranty under the ASU will also be deferred in the initial year of receipt for tax purposes under the provision permitted for advance payments.

18.4 Step 3 — Determine the Transaction Price

The new revenue standard requires an entity to estimate variable consideration and include the variable consideration in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Variable consideration may include discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised amount of consideration must also be adjusted for the effects of the time value of money if the contract contains a significant financing component.

In contrast, variable or contingent revenue is not recognized under general U.S. federal income tax principles until the amounts are fixed and determinable. Therefore, a book-to-tax adjustment is required.

18.4.1 Volume Discount Incentive (Example 24 in ASC 606-10-55-216 Through 55-220) — Tax Implications

In Example 24 of ASC 606 (reproduced in Section 6.2.5.4), the price per unit of Product A is reduced by the entity's volume discount incentive on the basis of the entity's experience and the new fact that the customer's purchases are estimated to exceed the 1,000-unit threshold for the calendar year. Under the tax economic performance rules, however, the price per unit of Product A will not be reduced by the volume discount incentive for U.S. federal income tax purposes since this item is treated as a refund liability that will not be taken into account until the customer's actual purchases exceed the 1,000-unit threshold under the contract and payment is made.

Further, in a manner similar to how the tax economic performance rules treat the volume discounts described above, those rules do not permit the deduction of estimated product returns from taxable income until the returns actually occur. Therefore, for tax reporting purposes, the effects of estimated product returns are added back to book income when the income tax provision is calculated. The changes made by the new revenue standard to the financial accounting treatment for sales returns are likely to have a significant impact on this process. Under the new guidance, estimated product returns must be recorded gross on an entity's balance sheet (i.e., an asset is recorded for the recovery of the product, and a liability is recorded for the refund that will be due to the customer). In current practice, most entities credit a sales return reserve and debit a returns expense. As a result of the requirement to record the amounts gross, an entity will need to adjust its tax account mapping to capture the appropriate amount of the estimated product returns. Instead of calculating the adjustment by using the reserve account, as is done in current practice, an entity will have to consider the gross treatment for financial statement purposes when determining the appropriate adjustment to be made for tax reporting purposes.

18.5 Step 4 — Allocate the Transaction Price to the Performance Obligations

The allocation of the transaction price to multiple performance obligations in a contract can create significant differences between book and tax treatment. Whereas the new revenue standard requires the transaction price to be allocated to each performance obligation on a relative stand-alone selling price basis, the tax rules generally respect the form of the contract and require the transaction price to be allocated in accordance with the prices stated in the contract.

18.5.1 Allocation Methodology (Example 33 in ASC 606-10-55-256 Through 55-258) — Tax Implications

In Example 33 of ASC 606 (reproduced in Section 7.1), an entity that has entered into a contract with a customer to sell Products A, B, and C is required to allocate the transaction price of $100 to the performance obligations on a relative stand-alone selling price basis. Accordingly, upon determining that the stand-alone selling prices of Products A, B, and C are $50, $25, and $75, respectively, the entity allocates $33 of the transaction price to the performance obligation for Product A ($50 ÷ $150 × $100), $17 of the transaction price to the performance obligation for Product B ($25 ÷ $150 × $100), and $50 of the transaction price to the performance obligation for Product C ($75 ÷ $150 × $100).

Under the tax rules, if the contract in Example 33 provided that the entity will sell Products A, B, and C for $33.33 each as an incentive for purchasing the bundle of goods, the sales price for each product would generally be respected. Accordingly, if the entity sells Products A and B in 20X8 and sells Product C in 20X9, revenue of $66.66 and $33.33 would be recognized in 20X8 and 20X9, respectively, for tax purposes. In contrast, $50 would be recognized under the ASU for each of the two years ($33 for Product A plus $17 for Product B in 20X8, and $50 for Product C in 20X9).

18.6 Step 5 — Determine When to Recognize Revenue

For U.S. federal income tax purposes, income is reported in the taxable year in which the right to the revenue becomes fixed and determinable. An amount is considered fixed at the earliest of when (1) payment is made, (2) payment is due, or (3) performance has occurred. As noted above, the tax laws provide special rules for recognizing revenue for certain types of transactions. For example, if a taxpayer receives an advance payment for the future sale of goods or provision of services, the taxpayer is permitted to (1) recognize the advance payment in the taxable year of receipt to the extent that the revenue is recognized for financial reporting purposes and (2) defer the remaining amount of the advance payment to the next succeeding taxable year. Thus, for a taxpayer using this special method, if revenue recognition is accelerated for financial reporting purposes under the new revenue standard (e.g., contingent revenue), there will be a corresponding acceleration in the recognition of the advance payment in the taxable year of receipt for federal income tax purposes. Because advance payments are recognized for tax purposes in accordance with the financial accounting method used for the year of receipt, the use of the new method of recognizing advance payments in a taxpayer's financial statement is considered a change in method of accounting for tax purposes.

Special tax rules also provide that certain entities that enter into long-term construction or manufacturing contracts must report taxable income by using the percentage-of-completion method. Under the percentage-of-completion method, income is recognized as costs are incurred. The reclassification of an item from an asset to a liability when a performance obligation is identified under the new revenue standard may affect the timing and amount of the costs incurred and deducted under the percentage-of-completion method.

18.6.1 Bill-and-Hold Arrangement (Example 63 in ASC 606-10-55-409 Through 55-413) — Tax Implications

Example 63 of ASC 606 (reproduced in Section 8.6.7) illustrates a bill-and-hold arrangement in which an entity recognizes revenue from the sale of spare parts it is storing at the customer's request. The revenue is recognized as of December 31, 20X9, when the entity received payment for the spare parts and transferred control of the spare parts to the customer.

For tax purposes, revenue from the sale of the spare parts in Example 63 would be recognized in 20X9 even if the customer did not have control of the spare parts because the entity has already received payment from its customer for the spare parts in 20X9. However, the amount would represent an advance payment if the entity received payment before the customer obtained control of the spare parts. Consideration should be given to the special tax rules for advance payments to determine whether there is a book-to-tax adjustment.

18.7 Licensing

The nature of an entity's promise to grant a license to a customer is to provide the customer with either (1) a right to access the entity's IP throughout the license period or for the license's remaining economic life if shorter (a "symbolic license") or (2) a right to use the entity's IP as it exists at the point in time when the license is granted (a "functional license"). Revenue is recognized accordingly under the new revenue standard (see Chapter 11 for further discussion of licensing transactions).

For tax purposes, however, the tax rules provide that revenue from the license of IP is recognized over the period in which the licensed property is used, without distinction between the right to access and the right to use the entity's IP. Whether the transaction is a license or a sale of IP must be analyzed for tax purposes.

18.7.1 Right to Use IP (Example 59 in ASC 606-10-55-389 Through 55-392) — Tax Implications

In Example 59 of ASC 606 (reproduced in Section 11.4), an entity licenses to a customer a right to use a recorded symphony in all commercials for two years in Country A. Under the ASU, it is determined that the revenue from the license is recognized at a point in time.

For tax purposes, the revenue from licensing the right to use the recorded symphony must be recognized ratably over the two-year period instead of at the point in time the right to use the IP is granted. If a taxpayer receives payment in advance of providing the right to use (or access) a license, it would need to consider the special tax rules for advance payment discussed in Section 18.6.

18.8 Customer Contracts

Under current U.S. GAAP, entities may analogize the accounting for revenue contracts to the guidance in ASC 310-20, which requires certain contract costs, including costs to acquire a contract (e.g., sales commissions), to be capitalized and amortized. In general, for U.S. federal income tax purposes, the costs paid to another party to enter into a contract with that customer, or amounts paid to nonemployee third parties to facilitate entering into a contract, must be capitalized if (1) the contract term exceeds 12 months and (2) the contract is not terminable at will by the other party to the contract. However, certain internal costs, such as employee compensation and overhead costs, may be deductible for tax purposes.

18.8.1 Incremental Costs of Obtaining a Contract (Example 1 in ASC 340-40-55-2 Through 55-4) — Tax Implications

ASC 340-40 (added by ASU 2014-09) provides examples of how an entity would account for various contract costs under the new revenue standard. In Example 1 of ASC 340-40 (reproduced in Section 12.2.2), an entity recognizes sales commissions paid to employees, which are incremental costs of obtaining a contract, as an asset because it expects to recover those costs through future fees for services provided under the obtained contract.

Although sales commissions paid to employees are capitalized as incremental costs of obtaining a contract under ASC 340-40, such costs are deductible for tax purposes. This is because the tax rules specifically exclude employee compensation as a capitalizable cost that facilitates the acquisition or creation of an intangible.

18.9 Implementing Changes in Tax Methods of Accounting

Before a taxpayer can change its tax method of accounting, the taxpayer must obtain consent from the IRS commissioner. In addition to changing from one alternative tax accounting method to another, if a taxpayer is using its book method as its tax method and the book method changes, the taxpayer must secure the commissioner's consent before changing to the new book method for U.S. federal income tax purposes. The consent from the IRS may be automatic or nonautomatic depending on the type of method change.

Revenue Procedure ("Rev. Proc.") 2015-13, as modified by Rev. Proc. 2015-33, provides the procedures, terms, and conditions for a taxpayer to obtain consent for a change in accounting method. The accounting method changes for which the IRS grants automatic consent are described in Rev. Proc. 2016-29. Automatic consent may or may not be granted depending on whether the taxpayer meets eligibility requirements and complies with certain terms and conditions. Method changes not included in Rev. Proc. 2016-29 are nonautomatic and therefore require the IRS's review and affirmative consent.

A change in method of accounting is generally effective as of the first day of the taxable year of the change. The change is effectuated through a cumulative catch-up adjustment that is equal to the difference between the use of the taxpayer's old and new methods of accounting for the item being changed as of the first day of the tax year of change (i.e., the adjustment is essentially a true-up for the item, as if the taxpayer had always used the new method of accounting). Subject to certain exceptions, if the adjustment results in an increase in taxable income, it is recognized ratably over four taxable years (or two taxable years, if the taxpayer is under IRS examination) beginning with the taxable year of change. If the adjustment results in a decrease in taxable income, the adjustment is recognized entirely in the taxable year of change.

Certain method changes are made without this adjustment (i.e., on a "cut-off" basis). For changes made on a cut-off basis, the new method is applied to transactions that originated on or after the first day of the tax year of change.

Q&A 18-1 Taxpayer Using Book Method of Accounting

When an entity implements the new revenue standard for its GAAP financial statements, it may overlook the tax implications of the new standard. Specifically, the entity may continue to apply its book method of accounting for calculating its taxable income after the book method changes under the new revenue standard, not taking into account whether this would also result in a change in method of accounting for tax purposes.

Question

What if the taxpayer has historically used its book method of accounting to calculate its revenue for taxable income, but the book method changes as a result of implementing the new revenue standard?

Answer

If the taxpayer has not secured consent from the IRS to change its tax accounting method, the taxpayer must maintain its current tax accounting method and keep additional records as a result. Additional recordkeeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

If the taxpayer changes its tax method of accounting without securing consent from the IRS, the taxpayer may be at risk if it comes under IRS examination. In general, upon filing an accounting method change request with the IRS, a taxpayer receives audit protection for its prior years' U.S. federal income tax returns. If the taxpayer does not file such a request, the IRS may raise the issue in the earliest tax year under examination and may require the taxpayer to use another, less favorable method of accounting.

18.10 Additional Tax Implications

In addition to considering the income tax implications discussed above, entities should evaluate the new revenue standard for the following implications:

- *Tax provision* — If an entity changes its tax method of accounting, it must comply with prescribed rules when including the change in its financial statements/provision for income taxes.
- *Indirect tax* — Impacts are expected when the basis of tax is book gross receipts, or when the tax base is not well defined. Depending on the industry, there could be significant impacts on the overall tax liability, and a specialist should be consulted to confirm that all aspects have been considered.
- *Global tax implications* — Any changes to the statutory financial statements can potentially affect tax measures based on the financial statements (e.g., thin capitalization limits, distributable reserves, and transfer pricing). In addition, the impact of cash taxes should be considered since there will be changes to the statutory financial statements.
- *Tax data and process* — As highlighted above, changes to both indirect taxes and tax accounting methods are possible. Systems and processes will need to be evaluated to ensure that they are revised and updated as necessary.

18.11 IRS Response to ASU 2014-09

In light of the new revenue standard, the IRS issued Notice 2015-40 to request comments on how the standard will affect taxpayers' methods of accounting. The IRS acknowledged that the new revenue standard raises "a number of substantive and procedural issues for the IRS, including whether the [new guidance contains] permissible methods of accounting for federal income tax purposes, the types of accounting method change requests that will result from adopting the new [revenue standard], and whether the current procedures for obtaining IRS consent to change a method of accounting are adequate to accommodate those requests."

Specifically, the government is working through the following issues in considering whether to release guidance on conformity between the new revenue standard and the IRC:

1. To what extent [does the new revenue standard] deviate from the requirements of [IRC Section 451]? How may [the new revenue standard] affect deferral of income?
2. What industry and/or transaction-specific issues may arise as a result of the new [revenue standard] that might be addressed in future guidance?
3. What types of changes in methods of accounting do taxpayers anticipate requesting?
4. Do taxpayers anticipate requesting changes in methods of accounting prior to the effective date of the new [revenue standard]?
5. Should taxpayers be required to use the automatic consent accounting method change procedures or the advance consent procedures to request permission to change a method of accounting under the new [revenue standard], and why?
6. Which accounting method changes under the new [revenue standard], if any, should be allowed using a cut-off method instead of [an IRC Section 481(a)] adjustment, and why?
7. Will advance or automatic consent procedures or other procedural guidance (such as Rev. Proc. 2004-34, 2004-22 I.R.B. 991) need to be modified and if so, how?
8. What transition procedures may be helpful?
9. What related accounting method changes do taxpayers anticipate requesting that may appropriately be made on a single Form 3115, *Application for Change in Accounting Method*?

Construction Ahead — Additional Developments

Additional developments related to income tax accounting methods are anticipated as the IRS gathers public comments and gains additional insight into the impact of the new revenue standard.

Chapter 19 — Stakeholder Activities

Since the issuance of ASU 2014-09 more than two years ago, the FASB has issued five additional final ASUs and two proposed ASUs to (1) defer the new revenue standard's original effective date, (2) provide certain technical corrections to the standard and (3) clarify certain aspects of the standard's guidance. There has also been significant activity by the joint revenue TRG and the AICPA revenue recognition industry task forces, along with involvement from regulators, including the SEC and the PCAOB. Given the far-reaching impact the new revenue standard will have on many industries, the level of implementation activity is not surprising. Although standard setting is nearly complete, stakeholders should continue to monitor activity at the FASB, SEC, and other standard-setting or regulatory bodies for any relevant developments or interpretations that may have an impact.

For a comprehensive collection of news and publications about the latest developments related to the new revenue standard, refer to Deloitte's US GAAP Plus Web site.

19.1 SEC Activities

19.1.1 In General

The SEC is a critical stakeholder given its role in both standard setting and regulating the U.S. capital markets. Much of U.S. GAAP's current revenue recognition guidance originated in SAB 101 and SAB 104, which are now included in SAB Topic 13. The SEC has indicated that it plans to review and update the revenue recognition guidance in SAB Topic 13 in light of ASU 2014-09. The extent to which the ASU's guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

In addition, upon the effective date of the new revenue standard, certain SEC observer comments will be removed (i.e., no longer effective) in accordance with ASU 2016-11. The removed SEC observer comments include ASC 605-45-S99-1 (formerly EITF Issue 00-10), which states that (1) shipping and handling fees billed to a customer are required to be classified as revenue and (2) the classification of shipping and handling costs incurred by the seller is an accounting policy decision. It is important to note that with the removal of this comment, it will most likely remain appropriate to present shipping and handling within costs of goods sold because they are considered to be fulfillment costs. See Section 19.2.2.4 below for further discussion of ASU 2016-11, which details the rescission of certain SEC guidance.

19.1.2 SEC Reporting Considerations Related to the Adoption of the New Revenue Standard

At the 2016 Baruch College Financial Reporting Conference, Wesley Bricker, the then deputy chief accountant in the SEC's Office of the Chief Accountant (OCA), commented on transition-period activities related to several of the FASB's recently issued accounting standards, including ASU 2014-09. His remarks addressed two significant reporting and disclosure matters that broadly affect SEC registrants: (1) SAB Topic 11.M disclosures and (2) the requirement for revised financial statements in a registration statement. In addition, in a separate meeting of the FASAC, the SEC staff addressed the requirements for selected financial data under Regulation S-K, Item 301. For further discussion, see Sections 19.1.2.1 through 19.1.2.3 below.

In March 2016, Topic 11 of the FRM was updated to address other SEC reporting considerations related to the adoption of the new revenue standard; these considerations are discussed in Section 19.1.2.4 through 19.1.2.6 below. Further, Section 19.1.2.7 discusses the SEC staff's recent views on the use of non-GAAP measures that adjust revenues.

19.1.2.1 SAB Topic 11.M Disclosures

At the 2016 Baruch College Financial Reporting Conference, Mr. Bricker emphasized the importance of providing investors with disclosures that explain the impact that new accounting standards are expected to have on an entity's financial statements ("transition disclosures").[1] Such disclosures provide investors with the information necessary to determine the effects of adopting a new standard and how the adoption will affect comparability period over period. Mr. Bricker highlighted the importance of "timely investor education and engagement" and presented examples of both successful and unsuccessful past transitions to new accounting standards. He indicated that transparent disclosure of anticipated impacts of a new standard in multiple reporting periods preceding its adoption has prevented market participants from reacting adversely to significant accounting changes. In a manner consistent with previous SEC staff comments on transition disclosures,[2] Mr. Bricker reiterated that "[i]nvestors should expect the level of disclosures to increase as companies make further progress in their implementation plans" in connection with newly issued standards.[3] For additional discussion on implementation disclosures, see Section 20.6.

[1] See SAB Topic 11.M.

[2] See Deloitte's December 15, 2015, *Heads Up* for more information.

[3] At the September 22, 2016, EITF meeting, the SEC observer reiterated the need to provide transparent transition disclosures that comply with the requirements of SAB Topic 11.M. The SEC observer indicated that when a registrant is unable to reasonably estimate the quantitative impact of adopting the new revenue standard, the registrant should consider providing additional qualitative disclosures about the significance of the impact on its financial statements. Refer to Deloitte's Financial Reporting Alert 16-3, "SEC Reminds Registrants of Best Practices for Implementing New Revenue, Lease, and Credit Loss Accounting Standards," for additional information about the SEC staff's recent comments on transition issues.

It should be noted that in a manner consistent with the SEC's views noted above, the European Securities and Markets Authority has issued a similar public statement for European issuers of public securities that will be adopting IFRS 15, reminding entities of the requirement to disclose an impending change in accounting policies for issued but not yet effective accounting standards and its expected impact on the financial statements.

19.1.2.2 Requirement for Revised Financial Statements in a Registration Statement

Registrants planning to use the full retrospective method of adoption have expressed concerns about the requirement to provide revised financial statements after the first quarter in which the new revenue standard is adopted but before filing a Form S-3[4] registration statement. If a registrant elects the full retrospective method of adoption and subsequently files a registration statement that incorporates by reference interim financial statements reflecting the impact of the adoption of the new revenue standard, it would be required to retrospectively revise its annual financial statements in its Form 10-K. Those financial statements would include one more year of retrospectively revised financial statements than the number of years that would be required if the registrant did not file a registration statement (the "fourth year").

For example, a calendar-year-end registrant adopts the new revenue standard on January 1, 2018, by using the full retrospective method and files its first quarter Form 10-Q on May 1, 2018. If the registrant files a Form S-3 on June 1, 2018, it is required under Form S-3, Item 11(b), to revise its previously filed annual financial statements retrospectively for the years ending 2017, 2016, and 2015 since financial statements for these years are required in the registration statement. If the registrant did not file a Form S-3, it would only be required to revise the two most recent prior comparative periods, 2017 and 2016, when it files its 2018 Form 10-K.

At the 2016 Baruch College Financial Reporting Conference, Mr. Bricker indicated that the SEC staff is aware of these concerns and acknowledged that while this requirement applies to any retrospective change, the "pervasive impact of the new revenue standard amplifies the issue." He noted that when adopting the new revenue standard, an entity should refer to the guidance under current U.S. GAAP on the adoption of new accounting standards and should therefore contemplate the impracticability exception to retrospective application. He further noted that "after making every reasonable effort to do so," a registrant could conclude that it is not practicable to apply the standard retrospectively to all periods required to be presented in a registration statement. Mr. Bricker emphasized that the OCA is available for consultation.[5]

19.1.2.3 Requirement for Selected Financial Data and Ratio of Earnings to Fixed Charges

Regulation S-K, Item 301, requires registrants to disclose specific items for each of the registrant's last five fiscal years and any additional fiscal years necessary to keep the information from being misleading. The SEC staff generally expects all periods to be presented on a basis consistent with the annual financial statements, including the annual periods presented before those included in the audited financial statements ("years 4 and 5"). The requirement to provide selected financial data was addressed

[4] While Mr. Bricker referred to Item 11(b) of Form S-3 at the 2016 Baruch College Financial Reporting Conference, other registration statements, such as Form S-4, include similar requirements.

[5] At the June 14, 2016, CAQ SEC Regulations Committee joint meeting with the SEC staff, the SEC staff indicated that while the OCA is available for consultation on this matter, consultation is not required.

by the SEC staff at the September 11, 2014, FASAC meeting, during which the SEC staff indicated that it would not object if a registrant's five-year table is consistent with its adoption of the standard as reflected in its financial statements.

Accordingly, for registrants using the full retrospective method to adopt the standard, application of the new revenue standard in the five-year table could be limited to only the most recent three years presented (i.e., years 4 and 5 do not need to be presented on the same basis as the annual financial statements). For registrants using the modified retrospective method, only the most recent fiscal year presented would be presented under the new standard. Regardless of the transition method adopted, a registrant would be expected to disclose:

- The method used to reflect the information (e.g., how the periods are affected).
- The fact that not all periods in the five-year table are comparable.

In addition, paragraph 11100.3 of the FRM indicates that registrants using the full retrospective method to adopt the standard do not need to retrospectively revise the ratio of earnings to fixed charges for years 4 and 5 when complying with the five-year requirement in Regulation S-K, Item 503(d).

19.1.2.4 Regulation S-X, Rules 3-09 and 4-08(g) — Financial Statements and Summarized Financial Information for Equity Method Investments

Under Regulation S-X, Rules 3-09 and 4-08(g), SEC registrants are required to evaluate the significance of an equity method investee in accordance with the tests in Regulation S-X, Rule 1-02(w) (i.e., the asset, income, or investment test), to determine whether they are required to provide the investee's financial statements or the investee's summarized financial information, or both. Under these rules, the prescribed significance tests are performed annually in connection with the filing of a Form 10-K (i.e., at the end of the registrant's fiscal year). Accordingly, significance is not remeasured when updated financial statements that reflect retrospective adjustments are filed in a Form 8-K (or are included in or incorporated into a registration statement).

As indicated in Topic 11 and paragraph 2410.8 of the FRM, when a change in accounting is retrospectively applied in financial statements included in a registrant's Form 10-K, the registrant is **not** required to recalculate the significance of an equity method investee under Rules 3-09 and 4-08(g). Therefore, for periods before the date of initial adoption of the new revenue standard, registrants are allowed to continue to measure significance of their equity method investees by using results from their preadoption financial statements.[6]

The SEC staff has further clarified in paragraph 11200.2 of the FRM that when measuring the significance of an equity method investee that adopted the new revenue standard as of a different date or by using a different transition method, a registrant does **not** need to conform the transition dates and methods of adoption.

[6] For a discontinued operation, a registrant should be mindful that significance under Rules 3-09 and 4-08(g) should be measured for each annual period presented in the financial statements on the basis of amounts that were retrospectively adjusted. Consequently, as a result of retrospective adjustments for a discontinued operation, a previously insignificant equity method investee may become significant. For additional information, refer to Deloitte's publication *A Roadmap to Reporting Discontinued Operations*.

19.1.2.5 Pro Forma Financial Information Under Article 11

Regulation S-X, Article 11, which establishes the requirements for pro forma information, lists various circumstances in which a registrant may be required to provide pro forma financial information, including when a significant business combination has occurred or is probable. If the financial statements of the significant acquired business (acquiree) adopts the new revenue standard as of a different date or under a different transition method, the registrant **must** conform the acquiree's transition dates and method of adoption when preparing the pro forma financial information under Article 11.

At the June 14, 2016, CAQ SEC Regulations Committee joint meeting with the SEC staff, the SEC staff discussed various reporting scenarios in which the acquiree (or investee under Regulation S-X, Rule 3-09) may need to adopt the new revenue standard before the registrant does so, creating complexities for the registrant when it considers pro forma requirements. These scenarios are currently being evaluated, and additional guidance may be forthcoming from the SEC staff.

19.1.2.6 Changes in Internal Control Over Financial Reporting

Registrants are required to disclose any material changes in their internal control over financial reporting (ICFR) in a Form 10-Q or Form 10-K in accordance with Regulation S-K, Item 308(c). Accordingly, registrants will need to be mindful of these disclosure requirements when establishing new controls and processes related to the adoption of the new revenue standard. For further discussion of ICFR, see Section 20.4.

19.1.2.7 Non-GAAP Financial Measures

In response to increasing concerns about the use of non-GAAP measures, the SEC staff updated its C&DIs in May 2016 to provide additional guidance on what it expects from registrants that use these measures. In Question 100.04 of the C&DIs related to non-GAAP financial measures, the SEC staff provides an example of a prohibited non-GAAP performance measure that adjusts revenue recognized over the service period under GAAP on an accelerated basis as if the registrant earned revenue when it billed its customers. The measure is prohibited because it is an individually tailored accounting principle and does not reflect the registrant's required GAAP measurement method.

In a July 6, 2016, webcast sponsored by TheCorporateCounsel.net, Mark Kronforst, chief accountant of the SEC's Division of Corporation Finance, clarified the views expressed by the SEC staff in its answer to Question 100.04 and confirmed that the "the bar is quite high" regarding a registrant's ability to present a non-GAAP performance measure that adjusts revenues. He indicated that registrants may present "bookings" or "billings" (with appropriate characterization) since such measures are not considered non-GAAP measures and can be useful disclosures.

Mr. Kronforst further indicated that the SEC staff may not object to the disclosure of non-GAAP performance measures that adjust revenue for the expected impact of the new revenue standard on current results. Use of such measures may be limited until registrants make further progress in their implementation plans in connection with the newly issued standard. When such measures are used, clear and transparent disclosures about the expected impact of the standard should be provided.

For more information, see Deloitte's publication *A Roadmap to Non-GAAP Financial Measures*.

19.2 FASB Activities

19.2.1 TRG Update

Upon issuing the new revenue standard, the FASB and IASB formed a joint revenue TRG. The purpose of the TRG is not to issue guidance but instead to seek and provide feedback on potential issues related to implementation of the new revenue standard. By analyzing and discussing potential implementation issues, the TRG helps the boards determine whether they need to take additional action, such as providing clarification or issuing other guidance. The TRG comprises financial statement preparers, auditors, and users from a "wide spectrum of industries, geographical locations and public and private organizations," and board members of the FASB and IASB attend the TRG's meetings. In addition, representatives from the SEC, PCAOB, IOSCO, and AICPA are invited to observe the meetings.

In January 2016, the IASB announced that it completed its decision-making process related to clarifying the new revenue standard and that it no longer plans to schedule TRG meetings for IFRS constituents. Therefore, starting in April 2016, the TRG meetings were FASB-only, but members of the IASB may participate as observers.

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, Mr. Bricker emphasized the importance of the TRG's continuing efforts, specifically those related to maintaining comparability between domestic registrants that file under U.S. GAAP and foreign private issuers that file under IFRSs. Therefore, while the IASB will no longer hold TRG meetings for IFRS constituents, it is important for foreign private issues to keep abreast of TRG developments in the United States.

For a topical and chronological listing of issues addressed by the TRG, see Appendixes D and E.

19.2.2 Final and Proposed ASUs

As noted above, the FASB has issued five final ASUs and two proposed ASUs to amend and clarify the guidance in the new revenue standard. Largely the result of feedback provided by the TRG, the Board's final and proposed updates to the new revenue standard are discussed throughout this Roadmap as applicable.

19.2.2.1 ASU 2015-14 on Deferral of the Effective Date

On August 12, 2015, the FASB issued ASU 2015-14, which defers the effective date of the Board's new revenue standard, ASU 2014-09, by one year for all entities and permits early adoption on a limited basis. Specifically:

- For public business entities, the standard is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods.

- For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the standard as of the following:
  - Annual reporting periods beginning after December 15, 2016, including interim periods.
  - Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the annual reporting period in which the new standard is initially applied.

See Section 15.1 for further details.

19.2.2.2 ASU 2016-08 on Principal-Versus-Agent Considerations

On March 17, 2016, the FASB issued ASU 2016-08, which amends the principal-versus-agent implementation guidance and illustrations in the new revenue standard. The FASB issued the ASU in response to concerns identified by stakeholders, including those related to (1) determining the appropriate unit of account under the revenue standard's principal-versus-agent guidance and (2) applying the indicators of whether an entity is a principal or an agent in accordance with the revenue standard's control principle.

Key provisions of the ASU include:

- *Assessing the nature of the entity's promise to the customer* — When a revenue transaction involves a third party in providing goods or services to a customer, the entity must determine whether the nature of its promise to the customer is to provide the underlying goods or services (i.e., the entity is the principal in the transaction) or to arrange for the third party to provide the underlying goods or services (i.e., the entity is the agent in the transaction). See Section 10.1 for further details.
- *Identifying the specified goods or services* — The ASU clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. As defined in the ASU, a specified good or service is "a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer." Therefore, for contracts involving more than one specified good or service, the entity may be the principal for one or more specified goods or services and the agent for others. See Section 10.1.1 for further details.
- *Application of the control principle* — To help an entity determine whether it controls a specified good or service before the good or service is transferred to the customer (and therefore determine whether it is the principal), the ASU added ASC 606-10-55-37A. See Section 10.2 for further details.
- *Indicators of control* — The ASU removes from the new revenue standard two of the five indicators used in the evaluation of control (i.e., exposure to credit risk and whether consideration is in the form of a commission). In addition, the ASU reframes the remaining three indicators to help an entity determine when it is acting as a principal rather than as an agent. Further, the ASU adds language to the indicators that explains how they are related to the control principle under the new revenue standard. See Section 10.2 for further details.

19.2.2.3 ASU 2016-10 on Identifying Performance Obligations and Licensing

On April 14, 2016, the FASB issued ASU 2016-10, which amends certain aspects of the new revenue standard, specifically the standard's guidance on identifying performance obligations and the implementation guidance on licensing. The amendments in the ASU reflect feedback received by the TRG.

ASU 2016-10 amends the new revenue standard on the following:

- Identifying performance obligations:
  - *Immaterial promised goods or services* — Entities may disregard goods or services promised to a customer that are immaterial in the context of the contract. See Section 5.2.3 for further details.
  - *Shipping and handling activities* — Entities can elect to account for shipping or handling activities occurring after control of the related good has passed to the customer as a fulfillment cost rather than as a revenue element (i.e., a promised service in the contract). See Section 5.2.4.2 for further details.
  - *Identifying when promises represent performance obligations* — The new guidance refines the separation criteria for assessing whether promised goods and services are distinct, specifically the "separately identifiable" principle (the "distinct within the context of the contract" criterion) and supporting factors. See Section 5.3.2.2 for further details.
- Licensing implementation guidance:
  - *Determining the nature of an entity's promise in granting a license* — Intellectual property (IP) is classified as either functional or symbolic, and such classification should generally dictate whether, for a license granted to that IP, revenue must be recognized at a point in time or over time, respectively. See Section 11.5 for further details.
  - *Sales- or usage-based royalties* — The sales- or usage-based royalty exception applies whenever the royalty is predominantly related to a license of IP. The ASU therefore indicates that an "entity should not split a sales-based or usage-based royalty into a portion subject to the recognition guidance on sales-based and usage-based royalties and a portion that is not subject to that guidance." See Section 11.6 for further details.
  - *Restrictions of time, geographical location, and use* — The ASU's examples illustrate the distinction between restrictions that represent attributes of a license and provisions that specify that additional licenses (i.e., additional performance obligations) have been promised. See Section 11.4 for further details.
  - *Renewals of licenses that provide a right to use IP* — Revenue should not be recognized for renewals or extensions of licenses to use IP until the renewal period begins. See Section 11.5.4 for further details.

19.2.2.4 ASU 2016-11 on Rescission of SEC Guidance Because of ASUs 2014-09 and 2014-16

On May 3, 2016, the FASB issued ASU 2016-11, which rescinds certain SEC guidance in light of ASUs 2014-09 and 2014-16. Specifically, ASU 2016-11 rescinds the following SEC guidance upon the adoption of ASU 2014-09:

- ASC 605-20-S99-2 (formerly EITF Issue 91-9) on revenue and expense recognition for freight services in process.
- ASC 605-45-S99-1 (formerly EITF Issue 00-10) on accounting for shipping and handling fees and costs.

- ASC 605-50-S99-1 (formerly EITF Issue 01-9) on accounting for consideration given by a vendor to a customer.
- ASC 932-10-S99-5 (formerly EITF Issue 90-22) on accounting for gas-balancing arrangements.

19.2.2.5 ASU 2016-12 on Narrow-Scope Improvements and Practical Expedients

On May 9, 2016, the FASB issued ASU 2016-12, which amends certain aspects of ASU 2014-09. The amendments address certain implementation issues identified by the TRG and clarify, rather than change, the new revenue standard's core revenue recognition principles. Changes include the following:

- *Collectibility* — ASU 2016-12 clarifies the objective of the entity's collectibility assessment and contains new guidance on when an entity would recognize as revenue consideration it receives if the entity concludes that collectibility is not probable. See Section 4.2.5 for further details.
- *Presentation of sales taxes and other similar taxes collected from customers* — Entities are permitted to present revenue net of sales taxes collected on behalf of governmental authorities (i.e., to exclude from the transaction price sales taxes that meet certain criteria). See Section 6.6 for further details.
- *Noncash consideration* — An entity's calculation of the transaction price for contracts containing noncash consideration would include the fair value of the noncash consideration to be received as of the contract inception date. Further, subsequent changes in the fair value of noncash consideration after contract inception would be included in the transaction price as variable consideration (subject to the variable consideration constraint) only if the fair value varies for reasons other than its form. See Section 6.4 for further details.
- *Contract modifications and completed contracts at transition* — The ASU establishes a practical expedient for contract modifications at transition and defines completed contracts as those for which all (or substantially all) revenue was recognized under the applicable revenue guidance before the new revenue standard was initially applied. See Chapter 15 for further details.
- *Transition technical correction* — Entities that elect to use the full retrospective transition method to adopt the new revenue standard would no longer be required to disclose the effect of the change in accounting principle on the period of adoption (as is currently required by ASC 250-10-50-1(b)(2)); however, entities would still be required to disclose the effects on preadoption periods that were retrospectively adjusted. See Chapter 15 for further details.

19.2.2.6 Proposed ASU on Technical Corrections

On May 18, 2016, the FASB issued a proposed ASU that would amend certain aspects of ASU 2014-09 and include technical corrections intended to clarify, rather than change, the new revenue standard's core revenue recognition principles.

The proposed technical corrections are related to the following issues:

- *Preproduction costs related to long-term supply arrangements* — The amendments in the proposed ASU would supersede the guidance in ASC 340-10 on preproduction costs related to long-term supply arrangements. Therefore, upon the adoption of the new revenue standard, an entity would account for costs related to a contract with a customer that were previously within the scope of ASC 340-10 by applying the guidance in ASC 340-40.
- *Impairment testing of capitalized contract costs* — The amendments in the proposed ASU would clarify that when an entity performs impairment testing of capitalized contract costs, it should (1) consider expected contract renewals and extensions and (2) include both the amount of consideration it already has received but has not recognized as revenue and the amount it expects to receive in the future.

- *Interaction of impairment testing of capitalized contract costs with guidance in other topics* — The amendments in the proposed ASU would clarify that impairment testing should be performed on assets outside the scope of ASC 340 (e.g., assets within the scope of ASC 330), then on assets within the scope of ASC 340, and then on asset groups and reporting units within the scope of ASC 360 and ASC 350, respectively.
- *Provisions for losses on construction- and production-type contracts* — The amendments in the proposed ASU would require an entity to determine the provision for losses at least at the contract level but allow the entity to determine the provision for losses at the performance obligation level as an accounting policy election.
- *Scope of ASC 606* — The proposed ASU would remove the term "insurance" from the scope exception in ASC 606 to clarify that all contracts within the scope of ASC 944 are excluded from the scope of ASC 606.
- *Disclosure of remaining performance obligations* — The amendments in the proposed ASU would provide practical expedients to the disclosure requirement related to remaining performance obligations in specific situations in which it is unnecessary for an entity to estimate variable consideration to recognize revenue. The amendments also would require expanded disclosures when an entity applies one of the practical expedients.
- *Illustrative example of accounting for the modification of a services contract* — The proposed ASU would amend Example 7 in ASC 606 to better align the example with the principles in ASC 606.
- *Fixed-odds wagering contracts in the casino industry* — The amendments in the proposed ASU would (1) create a new Subtopic 924-815 titled "Entertainment — Casinos — Derivatives and Hedging," which includes a scope exception from derivatives guidance for fixed-odds wagering contracts, and (2) add a scope exception to ASC 815 for fixed-odds wagering contracts issued by casino entities.
- *Cost capitalization for advisers to private and public funds* — The amendments in the proposed ASU would align the cost capitalization guidance in ASC 946 for advisers to both public funds and private funds.

In August 2016, the FASB affirmed its decisions related to the proposed technical corrections outlined above, except as follows:

- The Board decided to retain the guidance in ASC 340-10-25-2, which prescribes the accounting treatment for capitalization of molds, tools, and dies that a supplier will not own and that will be used in producing the products under a long-term supply arrangement.
- The Board directed its staff to perform further outreach and research on the proposed amendments related to the disclosure of remaining performance obligations required by ASC 606-10-50-13 through 50-16. The Board specifically requested that the staff meet with users and prepare examples of the types of disclosures that may be required for different types of revenue streams for discussion at a future Board meeting.

19.2.2.7 Proposed ASU on Additional Technical Corrections

On September 19, 2016, the FASB issued a proposed ASU that would make additional technical corrections (the "phase 2 amendments"). These phase 2 amendments were not included in the proposed ASU issued on May 18, 2016 (see Section 19.2.2.2 below), because they were not identified until after the initial January 20, 2016, Board meeting on revenue technical corrections.

The proposed additional technical corrections are related to the following issues:

- *Loan guarantee fees* — The proposed ASU would amend ASC 310-10-60-4 and ASC 942-825-50-2[7] to clarify the scope of the new revenue standard with respect to fees from financial guarantees.
- *Advertising costs* — The amendments in the proposed ASU would reinstate the guidance in ASC 340-20-25-2, which addresses the accrual of certain advertising expenses.
- *Refund liability* — The amendments in the proposed ASU would clarify Example 40 of ASC 606 by removing the reference to "contract liability" to describe a refund obligation.
- *Contract asset versus receivable* — The proposed ASU would amend Example 38, Case B, of ASC 606 to "more clearly link the analysis in that example with the receivables presentation guidance in [ASC] 606-10-45-4."[8]

19.3 AICPA Revenue Recognition Industry Task Forces

The AICPA formed 16 industry task forces to help develop an accounting guide on revenue recognition for entities in the following industries:

- Aerospace and defense.
- Airlines.
- Asset management.
- Broker-dealers.
- Construction contractors.
- Depository institutions.
- Gaming.
- Health care.
- Hospitality.
- Insurance.
- Not-for-profit.
- Oil and gas.
- Power and utility.
- Software.
- Telecommunications.
- Timeshare.

Refer to the AICPA's Web site for further information about the industry task forces and the lists of potential implementation issues being addressed by the respective task forces.

7 The proposed technical corrections to ASC 310-10-60-4 and ASC 942-825-50-2 were also discussed at the April 18, 2016, TRG meeting; see Deloitte's April 20, 2016, *TRG Snapshot* for additional information.

8 Quoted from the handout for the FASB's August 31, 2016, meeting.

Chapter 20 — Implementation Activities

Although the effective date of the new revenue standard is over a year away, entities should not wait to begin the implementation process. While the impact of adoption will vary by industry, it is important for all entities to have an implementation plan in place well in advance of the effective date to ensure that they fully consider all components affected by adoption of the standard before moving forward. It will be imperative even for entities that expect adoption of the new revenue standard to have only a minimal quantitative impact on their financial statements to identify and critically evaluate all of their contracts to confirm their initial expectation of the impact upon adoption. Further, even if a change in accounting policies is not expected, entities will need to perform a critical evaluation of their contracts with customers to comply with the new disclosure requirements in the standard, which may require additional financial data that may not be readily available from an entity's current IT system(s).

The process of gathering and analyzing information during the early stages of adopting the new revenue standard will play a critical role in providing decision makers with the information necessary to ensure that an entity has considered all potential scenarios and related outcomes before finalizing its plan for adoption. Entities will also use the information gained to weigh the advantages and disadvantages of each transition method (i.e., full retrospective or modified retrospective), although other factors, such as industry practice, may also influence an entity's transition approach.

The objective of this chapter is to (1) help entities begin their planning and assessment process and (2) provide entities that might be a little further along with adoption some ideas to supplement their current implementation approach and ensure that they consider all critical steps in the process. To achieve this objective, this chapter is laid out as follows:

- *Getting Started (Section 20.1)* — This section provides readers with helpful tips and some of our suggested "dos" and "don'ts" for implementing the new revenue standard. Entities should keep these dos and don'ts in mind not only at the beginning of the implementation process, but throughout the entire implementation process.
- *Roadmap for Implementation (Section 20.2)* — Our illustrative roadmap highlights key activities that an entity may consider including in its own roadmap for implementing the new revenue standard, along with an approximate length of time that each activity will take to complete.
- *Important Decisions (Section 20.3)* — In addition to the activities listed in the roadmap, this section focuses on four key decisions that an entity will need to make to adopt the new revenue standard.
- *Internal Control Over Financial Reporting (Section 20.4)* — This section discusses the potential changes to an entity's internal controls that could result from the increased judgments under the new revenue standard.
- *Practical Expedients (Section 20.5)* — This section discusses the multiple practical expedients provided to ease the burden of implementing the new revenue standard.
- *Other Considerations (Section 20.6)* — The remainder of Chapter 20 summarizes other considerations that entities should keep in mind during the adoption process — specifically, (1) SAB Topic 11.M disclosure requirements and (2) predecessor and successor audit considerations in the period of adoption.

20.1 Getting Started

The adoption of the new revenue standard may seem like a daunting task for entities that have contracts within the scope of ASC 606, but with the development of a detailed and thoughtful implementation plan, entities will be able to break down the transition into multiple stages so that they can work toward incremental and achievable goals.

Before charting a course for transitioning to ASC 606, all entities should consider the following dos and don'ts:

- Dos:
  - Identify a cross-functional team of professionals from all key decision-making departments within the entity's organization (e.g., Accounting, Finance, IT, Tax, HR, Sales, Investor Relations, Legal, Internal Audit) to ensure that all departments are represented before management agrees on a plan for transitioning to ASC 606. This task may include establishing a steering committee, program management team, or both, made up of individuals across functions and business units. In addition, global or multinational entities should identify key contacts in each international region, especially if business models differ internationally.
  - Create a realistic/achievable roadmap with key milestones for the entity to work toward to transition to ASC 606. Appendix F provides an illustrative roadmap to help entities develop a plan for implementation. Refer to Section 20.2 for additional information on the key activities in our roadmap.
  - Keep all affected departments abreast of the transition plan. This is especially important given the pervasive nature of many of the changes in ASC 606 from existing revenue guidance. Historically, entities have not involved departments outside of accounting (e.g.,

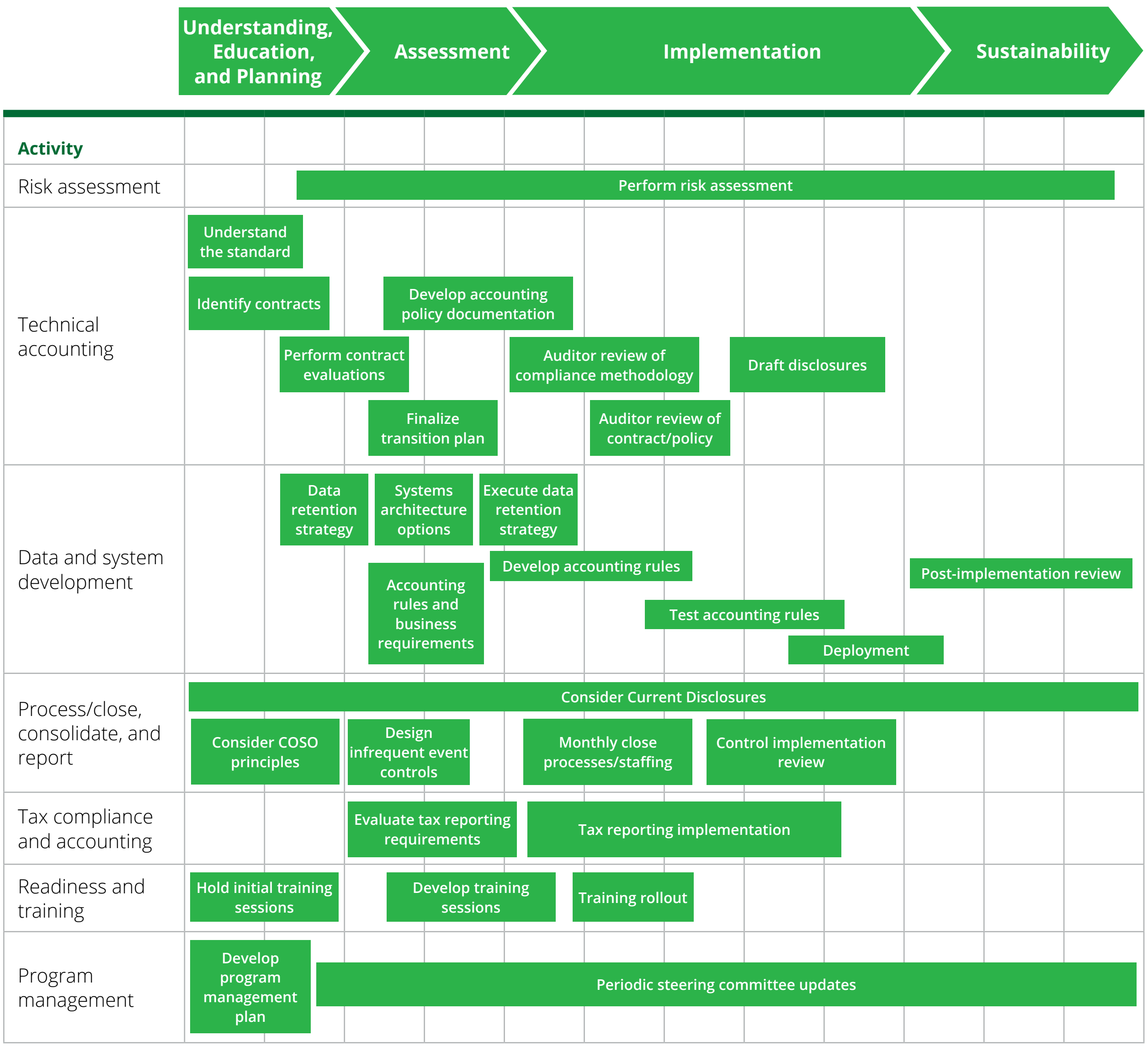
IT, Tax, HR, Sales, and Legal) in decisions related to the implementation of new accounting guidance issued by standard setters such as the FASB and IASB.

- Consider the various system solutions available to comply with the requirements in the new revenue standard.
- Leverage knowledge and efficiencies gained from the adoption of other accounting standards.
- Engage with auditors early in the implementation process to obtain concurrence on an entity's accounting policies and positions under the new revenue standard.
- Use available tools and resources, including, but not limited to, the following:
  - *Deloitte's* Heads Up *publications* — These newsletters provide updates on, and insights into, standard setting on revenue recognition that has taken place since the original issuance of the new revenue standard in May 2014.
  - *Deloitte's industry Spotlight series* — Publications in this series discuss the impact of the adoption of ASC 606 on more than a dozen industries, including aerospace and defense, financial services, life sciences, and telecommunications.
  - *Deloitte's* TRG Snapshot *publications* — These newsletters are issued after each TRG meeting to summarize the topics discussed and views expressed by the TRG.

- Don'ts:
  - Do not assume that ASC 606 does not have a significant impact on the entity.
  - Do not underestimate the time and resources necessary to appropriately implement ASC 606. Even for entities that might not be significantly affected upon transition to ASC 606, the effort involved in updating accounting policies and internal controls should not be underestimated.
  - Do not overlook the new information that will most likely be needed for the entity to comply with the new revenue standard's disclosure requirements.
  - Do not wait until the year of adoption to begin assessing the impact of the new standard.
  - Do not include only a small group of accounting personnel on the transition/implementation team.
  - Do not forget to download the Basis for Conclusions of (1) ASU 2014-09 (as issued) and (2) subsequently issued ASUs that update ASC 606. Each ASU's Basis for Conclusions provides insights into why the FASB and IASB decided to include certain guidance in the new revenue standard and should be used in conjunction with the codified guidance in ASC 606 and ASC 340-40.
  - Do not make decisions in silos. Specifically, do not (1) make IT design decisions before identifying business and functional requirements or (2) make business decisions without the involvement of IT.
  - Do not forget about the new quantitative and qualitative disclosure requirements when identifying the data needs and building the business/functional requirements.
  - Do not rely on Microsoft Excel as a viable solution for all changes associated with adoption.

20.2 Roadmap for Implementation

One of the key ingredients for a successful adoption of the new revenue standard is putting together a roadmap for implementation. Included below (and described in more detail in Appendix F) is our illustrative roadmap, which may help entities as they prepare their own roadmaps. The purpose of our illustrative roadmap is to outline the key activities that an entity may consider when developing its own roadmap, as well as some broad expectations of the time and effort needed for an entity to complete certain steps in transitioning to ASC 606.



Although the illustrative roadmap shown above may be a good starting point for entities, the activities and timing for each entity's roadmap will vary depending on (1) the industry or industries in which the entity operates, (2) the variability of the entity's contract types, (3) existing systems and processes, and (4) the amount of resources dedicated to the transition plan.

As illustrated, adoption of the new revenue standard is an iterative process that will require involvement of stakeholders throughout the organization. Further, while the initial steps of an adoption plan logically focus on the technical accounting issues, other aspects of the project can occur contemporaneously. As certain technical accounting conclusions are reached, tax and IT/systems implications can be assessed, internal training can begin, and pro forma impacts can be modeled. Conversely, an entity may need to revisit certain technical accounting conclusions later in the adoption process. Accordingly, the adoption of the new revenue standard should not be viewed as a linear process.

Sections 20.2.1 through 20.2.4 below discuss the four phases of adopting the new revenue standard, as illustrated in our illustrative roadmap.

The four phases of adopting the new revenue standard are (1) understanding, education, and planning; (2) assessment; (3) implementation; and (4) sustainability. There are key activities associated with each phase of adoption. Certain of these activities may be performed during multiple phases of the adoption process, while others may apply to a single phase. Sections 20.2.1 through 20.2.4 highlight some of the activities associated with each phase. For a complete listing of the activities associated with each phase, refer to Appendix F.

20.2.1 Phase 1: Understanding, Education, and Planning

Technical accounting activities are a key aspect of the understanding, education, and planning phase. However, there are many other activities associated with the first phase of the adoption effort. Sections 20.2.1.1 through 20.2.1.4 below discuss a number of the significant activities performed during this initial phase.

20.2.1.1 Technical Accounting Activities

One of the first steps an entity must take in creating a transition plan for ASC 606 is to identify and evaluate all significant types of contracts within the entity. This analysis could be performed at many different levels, and there is no one-size-fits-all approach. An entity with contracts that are largely homogeneous may complete a review at a relatively high level, whereas an entity with contracts that vary significantly (e.g., with respect to contract term, pricing, or goods and services delivered) may need to take a more granular approach. After determining the appropriate level at which to perform the analysis of each key contract type, an entity should walk through the five-step model for each contract type to determine the impact of the new guidance upon the adoption of ASC 606. It is important for an entity to apply the entire five-step model to sampled contracts to determine the impact the new revenue standard will have on the revenue recognition profile. Often, an entity that performs a detailed analysis of a contract by using the five-step model will identify changes and challenges that would not have been obvious from a cursory review of the contract. The result of the analysis should allow the entity to understand key changes that will arise upon adoption.

When analyzing contracts, entities should consider other changes to current practice that may result from the issuance of the new revenue standard, including changes that do not affect revenue. For example, the guidance in ASC 340-40[1] on incremental costs of obtaining a contract, which is added by the new revenue standard, will require all entities to gather information related to incremental costs of obtaining contracts to assess whether capitalization of such costs is appropriate. Refer to Chapter 12 for additional information on the accounting for such costs.

When performing its contract analysis, an entity may want to consider:

- Compiling a complete inventory of contracts to identify standard, unique, and complex contracts for review.
- Documenting key terms and conditions in each contract, identifying data within each contract that may be relevant to accounting for the contract under the new standard (e.g., performance obligations, transaction pricing, material rights, contingencies), and beginning to evaluate the implications of contract terms and conditions under the new revenue standard.
- Reviewing existing whitepapers, narratives, and process flows to understand current accounting policies, and assessing those policies for potential change.

In analyzing details for each contract type, an entity should consider documenting how it meets the criteria related to the following guidance in the new revenue standard, which closely aligns with the five-step model in ASC 606:

- Identifying the contract (i.e., determining whether the agreement identified represents a contract as defined by ASC 606[2]).
- Identifying performance obligations.[3]
- Determining the transaction price.[4]
- Allocating the transaction price.[5]
- Determining the amounts of revenue to recognize in each relevant period to be presented in the financial statements.
- Determining the accounting for any incremental costs incurred in obtaining or fulfilling a contract.[6]

In determining broad categories for various contracts and also understanding the key differences between existing revenue guidance and ASC 606, the transition team will be able to further disaggregate the contracts and begin developing a framework in which to build accounting policy memos and flowcharts to aid in the transition to ASC 606 upon adoption.

20.2.1.2 Process/Close, Consolidate, and Report

As part of the first phase of the adoption process, an entity should consider its current disclosures (e.g., footnote disclosures in Forms 10-K and 10-Q) to prepare for assessing how the disclosures may change as a result of the new revenue standard. In addition to understanding its current disclosures, an entity should determine the necessary disclosures required by SAB Topic 11.M. For further information on the disclosures in SAB Topic 11.M, see Sections 19.1.2.1 and 20.6.

[1] Specifically, ASC 340-40-25-1 through 25-4.
[2] See ASC 606-10-25-1.
[3] See ASC 606-10-25-14.
[4] See ASC 606-10-32-2.
[5] See ASC 606-10-32-28.
[6] See cost guidance in ASC 340-40.

An entity should also consider the relevant principles and points of focus in COSO's *Internal Control — Integrated Framework*, as updated in 2013 (the "2013 COSO Framework"). For additional considerations related to internal controls, see Section 20.4.

Further, SEC registrants are required to disclose any material changes in their internal control over financial reporting (ICFR) in a Form 10-Q or Form 10-K in accordance with Regulation S-K, Item 308(c).

20.2.1.3 Readiness and Training Activities

Given the likely differences between an entity's existing revenue recognition policies and the requirements under ASC 606, developing a training plan for employees will be a critical step in the adoption process. In addition to ensuring that their employees have a fundamental understanding of the standard, entities will need to develop training materials or procedures for their employees that are dynamic and readily adjusted with updates based on TRG meetings, AICPA working group implementation efforts, and other potential standard-setting activities that might occur after the entities' first training activities related to the adoption of ASC 606. Entities with international operations will also need to develop a plan for rolling out technical training activities and related materials on a global scale to ensure that all necessary information is disseminated to employees at all levels.

Regardless of whether an entity chooses to provide updates via internal conference calls, develop training materials in-house to distribute to employees, or seek assistance from an outside course development vendor or other professional services firms, the entity will need to ensure that all employees who have a role in its revenue cycle are aware of the new revenue standard at a fundamental level and have resources available to them if further research or assistance is required.

20.2.2 Phase 2: Assessment

The second phase of the adoption effort is the assessment phase. During the assessment phase, entities are likely to continue performing some of the activities described in the understanding, education, and planning phase (see Sections 20.2.1 through 20.2.1.3). In addition, entities will perform new activities, as described in the sections below.

20.2.2.1 Technical Accounting Activities

As noted above, some activities may be performed during multiple phases of an entity's adoption efforts. This is the case for certain of the technical accounting activities, such as contract evaluations. The main technical accounting activities that are performed in the assessment phase are (1) contract evaluations, (2) documentation of accounting policies, and (3) final development of a transition plan.

Evaluating contracts is an iterative process. Consequently, there is no set rule on when an entity should perform this task. However, as the entity begins to understand more about its contract types and the key terms and conditions within each contract, it may be inclined to assess the contracts at a more granular level during the assessment phase of the adoption effort. Accordingly, contract evaluations should be viewed as a continuous process during both phase 1 and phase 2 of the adoption process.

After evaluating its contracts, an entity will be able to determine and document its updated accounting policies under the new revenue standard. The determination and development of these accounting policies is an important decision that entities will need to make. Therefore, entities should ensure that they (1) dedicate enough time and resources to the development of these policies and (2) obtain auditor concurrence before finalizing these policies. For additional information, see Section 20.3.3.

Another important decision that an entity should make during the assessment phase is to determine the transition method that it will use to adopt the new revenue standard (i.e., full retrospective or modified retrospective method). This decision is described in further detail in Section 20.3.1. For assistance in making this decision, the entity may prepare pro forma financial statements that illustrate the potential impact of the new revenue standard on financial statements and key metrics.

20.2.2.2 Data and System Development Activities

Once an entity is partially through its technical accounting assessment, it may begin assessing activities related to data and system development. Specific activities include, but are not limited to, developing both business and functional requirements. The purpose of developing business requirements is to (1) present and document the key requirements for any system changes that are needed and (2) identify the data requirements and billing or ledger systems affected by the new revenue standard. The objective of developing functional requirements is to develop granular accounting calculation rules that an entity's system will need to perform. Although the development of business and functional requirements is primarily an IT activity, entities should review these requirements with other business functions (e.g., technical accounting) to ensure that the requirements are sufficient.

20.2.2.3 Tax Compliance and Accounting Activities

As part of the assessment phase, entities should begin thinking about the impact of the financial reporting changes on tax reporting requirements. For specific tax considerations, see Chapter 18.

20.2.3 Phase 3: Implementation

The third phase of the adoption effort is the implementation phase, which includes activities related to (1) technical accounting, (2) data and system development, and (3) readiness and training. These activities are discussed below.

20.2.3.1 Technical Accounting Activities

In addition to the other technical accounting activities that may carry over from the assessment phase, one of the key activities during the implementation phase will be the drafting of disclosures required by the new revenue standard. ASC 606[7] requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."[8] As further discussed in

[7] Specifically, ASC 606-10-50-1 through 50-23.
[8] Quoted from ASC 606-10-50-1.

Chapter 14, ASC 606 disclosure requirements, which are more comprehensive than existing disclosure requirements, include the following (subject to certain exceptions for nonpublic entities):

- Presentation or disclosure of revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts.
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors."[9] (The new revenue standard provides implementation guidance on such disclosure.)
- Information about (1) contract assets and contract liabilities (including changes in those balances), (2) the amount of revenue recognized in the current period that was previously recognized as a contract liability, and (3) the amount of revenue recognized in the current period that is related to performance obligations satisfied in prior periods.
- Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied)"[10] and when the entity expects to recognize that amount as revenue.
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).
- Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortization methods).
- Information about policy decisions (e.g., whether the entity used the new revenue standard's practical expedients related to significant financing components and contract costs).

Even if an entity concludes that the new revenue standard will not have a significant impact on the timing or the amount of revenue that is recognized, it is likely that the entity's disclosures (and information required to prepare disclosures) will change. In light of this, entities should prepare draft disclosures in accordance with the new revenue standard and review those disclosures with investor relations to ensure that the disclosures provided meet the objective in ASC 606-10-50-1. In addition, entities should perform a gap analysis by (1) identifying the data inputs necessary to comply with the disclosure requirements and (2) evaluating whether such data are already captured in an existing system.

20.2.3.2 Data and System Development Activities

Adoption of the new revenue standard could have a pervasive impact on an entity's IT systems because of the potential reallocation of revenue and differences in the timing of recognition between current U.S. GAAP and ASC 606.

In developing an approach to assess the potential need for modification of existing systems, an entity must first determine the required data elements, the related systems, and a data integration approach. If an entity does not have the internal expertise to assess the potential impact of adoption on its systems, seeking outside assistance from professional services firms or the ERP vendors themselves may be necessary to mitigate this potential risk. An entity may also need to consider any potential

[9] Quoted from ASC 606-10-50-5.
[10] Quoted from ASC 606-10-50-13.

differences between U.S. GAAP and IFRSs that system solutions may need to capture. Refer to Appendix A for a listing of differences between U.S. GAAP and IFRSs that may warrant consideration when an entity is designing system solutions.

While all entities should consult with their internal or external IT personnel before making a final decision about which system solutions to use upon adoption of ASC 606, Appendix F outlines some key steps to help inform entities about system modifications that may be required when the new revenue standard is adopted.

20.2.3.3 Readiness and Training Activities

In addition to training their employees on the technical accounting aspects of the new revenue standard, entities should educate employees on the updated accounting policies and controls established to comply with the new revenue standard. Entities should periodically touch base with their employees to continually ensure that the employees are applying the updated policies and controls.

20.2.4 Phase 4: Sustainability

Although adopting the revenue standard may seem like a one-time effort, the success of an entity's adoption efforts is partly dependent on the activities performed during the sustainability phase. After adopting the new revenue standard, entities should perform a post-implementation review to ensure that (1) any system modifications or upgrades are functioning as intended, (2) any changed or newly implemented internal controls are operating effectively, (3) the entities' personnel are following the new accounting policies, and (4) disclosures are comparable to those prepared by others in the same industry or industries. Depending on the outcome of the post-implementation review, some entities may need to continually dedicate resources to ensure compliance with the new revenue standard. Consequently, this phase of the process should not be dismissed.

20.3 Important Decisions

Discussed below are some of the important decisions that all entities should thoughtfully consider while transitioning to ASC 606. These important decisions correspond to activities and phases of the implementation roadmap, as discussed in Sections 20.2 through 20.2.4 above.

20.3.1 Determining a Transition Approach

Chapter 15 discusses the available methods of transition to ASC 606 (i.e., the full retrospective method under ASC 606-10-65-1(d)(1) and the modified retrospective method under ASC 606-10-65-1(d)(2)), along with related practical expedients.

In accordance with SAB 74 (codified in SAB Topic 11.M), an SEC registrant is required to disclose the method of transition to ASC 606 that it plans to use as soon as that election is made. Therefore, an SEC registrant should carefully consider early in its adoption process which transition method to apply.

The table below lists key observations and challenges related to each transition method.

	Full Retrospective	Modified Retrospective
Dual reporting requirements	• Prior two comparative years (potentially three) required to be restated.	• Dual recordkeeping required in the year of adoption.
Comparability	• Full comparability as prior periods are restated. • Cumulative catch-up adjustment recorded on January 1, 2016.	• No comparability between current year and prior periods on primary financial statements. • Year of adoption comparability provided in footnote disclosures. • Cumulative catch-up adjustment will be on January 1, 2018.
System considerations	• The full retrospective method will require information to be prepared and validated before January 2018. Procedural "trial runs" will provide opportunity to fix potential unforeseen or unplanned challenges.	• More time to develop a one-time transition plan with more runway to fix data and system challenges ahead of "go-live" in January 2018.

To expand on the table above, Sections 20.3.1.1 and 20.3.1.2 discuss some considerations in the evaluation of which adoption method to elect. Entities should bear in mind that the considerations are not all-inclusive but are likely to affect their decision.

20.3.1.1 Impact on Trends

For entities with standardized business models (e.g., ship and bill goods via short-term contracts), it is possible that the new revenue standard will not greatly affect current revenue recognition policies, procedures, or financial results. However, for entities with longer-term contracts, arrangements that include multiple performance obligations, arrangements with variable pricing (e.g., discounts), and arrangements that involve the licensing of intellectual property (including software), the new revenue standard is likely to have a more significant impact. While not the sole factor for determining which transition approach to apply, the impact on an entity's operations will play a role in that determination. An entity whose operations are not significantly affected by the adoption of ASC 606 might opt for the modified retrospective method so that it does not have to restate prior periods as it would be required to do under the full retrospective method, thereby minimizing the adoption effort. However, entities that expect the adoption of ASC 606 to have a significant impact on their operations might consider applying the full retrospective method to provide users of their financial statements with comparative three-year information and trends that result from fully restating prior periods in accordance with ASC 250. Even if the full retrospective method is not applied, financial statement users may request comparative information regardless of whether such information is provided outside of the financial statements (i.e., on earnings calls, in investor presentations, or in press releases).

20.3.1.2 Dual Reporting Requirements

An entity's IT systems, historical data, and resource limitations may also be a determining factor in the transition approach selected. Although an entity is not required to restate prior periods under the modified retrospective method, this transition method requires an entity to disclose the amount by which each financial statement line is affected in the current reporting period by the adoption of ASC 606 as compared with the guidance that was in effect before adoption.[11] That is, an entity will need to run parallel financial reporting systems for one year (the year of adoption) to capture revenue transactions under ASC 606 and "legacy GAAP" to satisfy the transition disclosure requirements under the modified retrospective method. Because the disclosure detailing the impact of adoption on each line item in the financial statements will be subject to audit, revenue recorded under both legacy GAAP and the new revenue standard will be subject to audit in the year of adoption. Entities selecting the modified retrospective adoption approach should consider any system and resource limitations that could affect their ability to run parallel financial reporting systems in the year of adoption.

Alternatively, the full retrospective method will require entities to capture information to report revenue under the new revenue standard for all periods presented in the year of adoption (and, potentially, one additional year for SEC registrants that file a registration statement in the year of adoption — see Section 19.1.2.2 for additional information). Although the full retrospective method requires an entity to restate prior periods presented, revenue recorded under both legacy GAAP and the new revenue standard by entities that apply the full retrospective method will not be subject to audit in the same year (i.e., entities that adopt the new revenue standard by using the full retrospective method do not need to disclose the impact of adoption on each financial statement line item). This is not the case for entities that use the modified retrospective method, as described in the paragraph above.

20.3.2 Individual-Contract Versus Portfolio Approach

In addition to electing a method of transition to ASC 606, an entity will need to determine whether it will apply the guidance in ASC 606 on a contract-by-contract or portfolio basis. Although ASC 606 should generally be applied on an individual-contract basis, an entity is permitted to apply a "portfolio approach" if it is reasonably expected that the portfolio approach's impact on the financial statements will not be materially different from the impact of applying the revenue standard on an individual-contract basis. The individual-contract versus portfolio approach is discussed further in Chapter 3.

Although the financial statement results should not differ materially as a result of applying a portfolio approach as opposed to an individual-contract approach, it is important for an entity to select an approach because the approach used may affect the entity's financial reporting processes and systems.

20.3.3 Accounting Policies

In conjunction with assessing system changes and other updates required upon adoption, refreshing accounting policies used under existing revenue guidance to reflect the guidance in ASC 606 will require a significant time commitment.

Entities will need to revise existing accounting policies to align them with the five-step model in ASC 606 as well as the new guidance in ASC 340 on contract costs. It is also important for an entity to discuss the revised accounting policies with its auditors to obtain concurrence on its accounting positions before formalizing system changes.

[11] See ASC 606-10-65-1(i)(1).

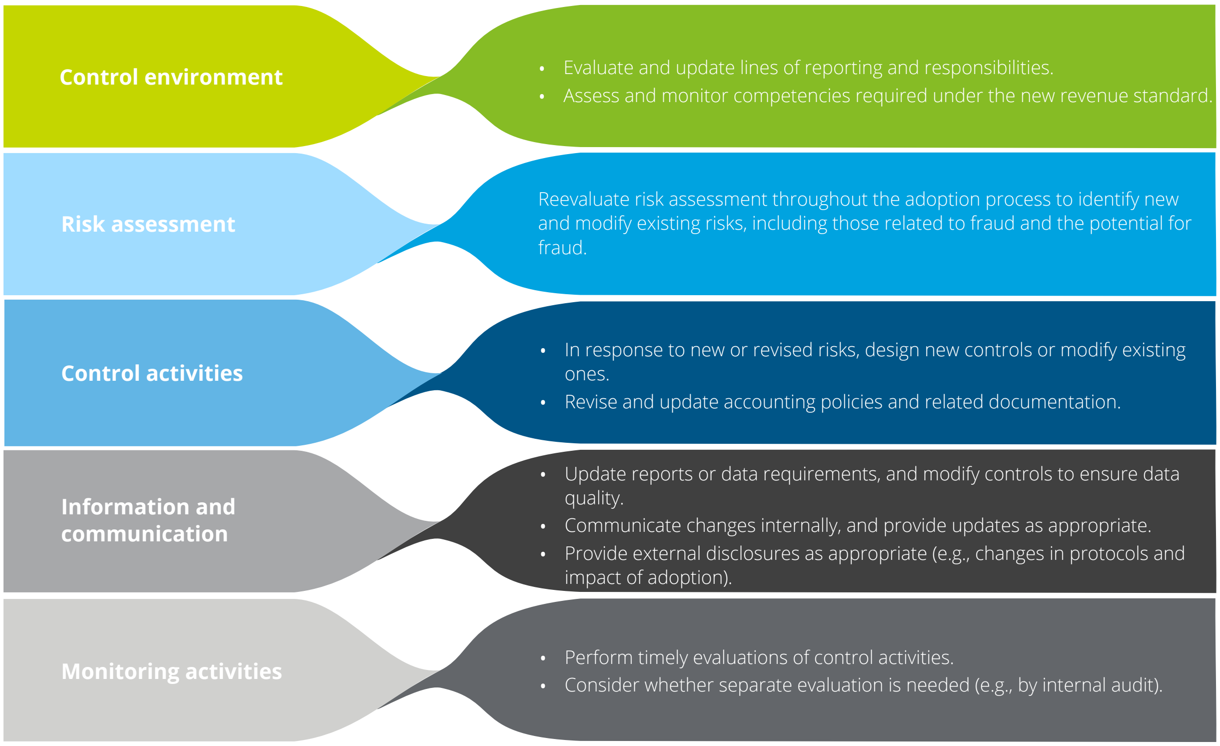
20.3.4 System Modifications

As discussed in Section 20.2.3.2, adoption of the new revenue standard could have a pervasive impact on an entity's IT systems. Entities should consider early on whether existing systems (e.g., ERP, billing, general ledger) are sufficient to capture the data and perform the calculations required under the new revenue standard. If an entity determines that its current systems are insufficient, it should decide whether to (1) perform certain revenue adjustment calculations outside of those systems if such changes are minor (e.g., in Microsoft Excel), (2) modify the current systems to meet the needs of the new revenue standard, or (3) implement a new system designed to comply with the new revenue standard. If an entity chooses to implement a new system, the entity should consider (1) whether the new system is on the same platform as the entity's existing systems and (2) whether the new system can be customized or tailored to meet the entity's specific needs. Because system implementations can often take more than a year to complete, entities should get started as soon as possible to ensure that there is adequate time in which to make any system changes.

20.4 Internal Control Over Financial Reporting

To ensure reliable financial reporting, an entity must maintain a strong system of internal control. Because an entity may adjust its financial reporting processes as a result of the new revenue standard, the entity may also be required to modify its ICFR. Specifically, entities should identify internal controls to address risks of material misstatement specific to the adoption and implementation of the new revenue standard. An entity may consider the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring activities) to begin the evaluation of needed modifications to its existing system of internal control. Consideration of relevant principles and points of focus in the 2013 COSO Framework provides a starting point for identifying new controls, or modifying existing controls, that pertain to the new revenue standard. The chart below illustrates considerations related to the five components of internal control.

Components of ICFR Under the 2013 COSO Framework



Entities need to make significant judgments in applying certain guidance in the new revenue standard (e.g., the guidance on estimating variable consideration, constraining variable consideration, and estimating stand-alone selling prices). Entities should design appropriate controls over the determination of such judgments, including those judgments that are required to be disclosed.

As stated above, entities may need to modify existing, or implement new, IT systems to capture additional information required by the new revenue standard. Entities will need to test (1) controls over their IT system modifications and implementations and (2) controls that address the accuracy and completeness of new information.

An entity's internal audit department could play a pivotal role in the evaluation of necessary modifications to the entity's ICFR, including, but not limited to, modifications related to (1) assessing risks, (2) identifying and designing (or redesigning) relevant controls, and (3) monitoring the effectiveness of control activities.

Since SEC registrants are required to provide periodic disclosures and certifications related to internal controls, management will need to evaluate the potential impact of any changes in internal controls on such disclosures and certifications.

In addition to internal controls over updated financial reporting processes, entities should consider the internal controls needed to comply with the SAB Topic 11.M disclosures. Refer to Section 20.6.1 for additional information.

Further, SEC registrants are required to disclose any material changes in their ICFR in a Form 10-Q or Form 10-K in accordance with Regulation S-K, Item 308(c).

20.5 Practical Expedients

In addition to evaluating the important decisions outlined in Section 20.3, an entity must make several policy elections and consider electing certain practical expedients upon adoption of the new revenue and cost guidance. The table below provides a summary of practical expedients available to entities either on a one-time basis during the period of adoption or on an ongoing basis. Entities are not required to adopt the practical expedients in ASC 606, but adoption of the expedients is likely to lessen the burden of implementing certain requirements in ASC 606.

Application	Codification Reference	Practical Expedient	Availability Under U.S. GAAP, IFRSs, or Both
Policy Elections Affecting the Measurement and Recognition of Revenue			
Ongoing	ASC 606-10-32-18	*Significant financing component* — An entity does not need to adjust the promised amount of consideration for the effects of a significant financing component if it expects, at contract inception, that the period between the entity's transfer of a promised good or service to a customer and the customer's payment for that good or service will be one year or less.	U.S. GAAP and IFRSs
Ongoing	ASC 606-10-32-2A	*Sales taxes* — An entity may elect to exclude from its transaction price any amounts collected from customers for all sales (and other similar) taxes.	U.S. GAAP only
Ongoing	ASC 340-40-25-4	*Costs of obtaining a contract* — An entity "may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less."	U.S. GAAP and IFRSs
Ongoing	ASC 606-10-25-18B	*Shipping and handling* — An entity may elect to account for shipping and handling activities that occur after control of the related good transfers as fulfillment activities instead of assessing such activities as performance obligations.	U.S. GAAP only
Ongoing	ASC 606-10-10-4	*Portfolio approach* — An entity may apply the new revenue standard to a portfolio of contracts (or performance obligations) with similar characteristics if it "reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio."	U.S. GAAP and IFRSs
Ongoing	ASC 606-10-55-18	*Right to invoice* — For performance obligations satisfied over time, "if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice."	U.S. GAAP and IFRSs

(Table continued)

<table>
<tr><th>Application</th><th>Codification Reference</th><th>Practical Expedient</th><th>Availability Under U.S. GAAP, IFRSs, or Both</th></tr>
<tr><td colspan="4">Policy Elections Affecting Disclosures</td></tr>
<tr><td>Ongoing</td><td>ASC 606-10-50-14</td><td>Disclosure:
• An entity may elect not to disclose the information about its remaining performance obligations in ASC 606-10-50-13 for a performance obligation if either of the following conditions is met:
a. The performance obligation is part of a contract that has an original expected duration of one year or less.
b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with [ASC] 606-10-55-18.
• If this practical expedient is elected, it should be applied entity-wide to all contracts.
• Stay tuned for future technical corrections after the FASB concludes deliberations related to its proposed ASU on technical corrections and improvements to ASU 2014-09.</td><td>U.S. GAAP and IFRSs; however, future amendments by the FASB may result in differences between U.S. GAAP and IFRSs.</td></tr>
</table>

(Table continued)

Application	Codification Reference	Practical Expedient	Availability Under U.S. GAAP, IFRSs, or Both
Transition Elections			
One-time	ASC 606-10-65-1(f)	*Transition:* • When an entity opts to apply the full retrospective method under ASC 606-10-65-1(d)(1), it may elect any of the following practical expedients: 1. An entity need not restate contracts that begin and are completed within the same annual reporting period. 2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. 3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue (see [ASC] 606-10-50-13). 4. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the [new revenue standard], an entity need not retrospectively restate the contract for those contract modifications in accordance with [ASC] 606-10-25-12 through 25-13. Instead, an entity shall reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented in accordance with the [new revenue standard] when: i. Identifying the satisfied and unsatisfied performance obligations ii. Determining the transaction price iii. Allocating the transaction price to the satisfied and unsatisfied performance obligations. • Any practical expedient in ASC 606-10-65-1(f) that is elected should be applied entity-wide to **all** contracts.	U.S. GAAP and IFRSs

For many of the practical expedients outlined above, the new revenue standard requires disclosure that an entity has elected such policy. See Chapter 14 for disclosure requirements.

20.6 Other Considerations

20.6.1 SAB Topic 11.M Disclosures

As discussed in Section 19.1.2.1, at the 2016 Baruch College Financial Reporting Conference, Wesley Bricker, the then deputy chief accountant in the SEC's Office of the Chief Accountant, emphasized the importance of providing investors with transition-period disclosures in accordance with SAB 74 (codified in SAB Topic 11.M). Such disclosures should include not only an explanation of the transition method elected (as discussed in Section 20.3.1) but also disclosures that explain the impact that the new revenue standard is expected to have on an entity's financial statements.

In providing key stakeholders with information about the expected impact of adoption on the financial statements, entities may need to develop pro forma financial statements (as discussed in Section 20.2.2.1) based on their anticipated transition method (full retrospective or modified retrospective) to appropriately estimate the impact of adoption. There will not be a one-size-fits-all model for communicating the impact of adoption, but entities could consider providing (1) a short narrative that qualitatively discusses the impact of the change or, to the extent available, (2) tabular information (or ranges) comparing historical revenue patterns with the expected accounting under ASC 606. If an entity elects to discuss the qualitative aspects of its expected change, the entity may make some or all of the following types of disclosures depending on its specific facts and circumstances:

Illustrative Disclosures — Adoption of New Accounting Standard

- We expect to identify [more/less/similar] performance obligations under ASC 606 as compared with deliverables and separate units of account previously identified. As a result, we expect the timing of our revenue [to occur in earlier periods/to occur in later periods/remain the same].
- [Many/Some/A few] of our contracts [in X business unit/Y segment/Z geography] include contingent amounts of variable consideration that we were precluded from recognizing because of the requirement for amounts to be "fixed or determinable" under SAB Topic 13. However, we anticipate that ASC 606 will require us to estimate these amounts. As a result, we expect to recognize revenue earlier under ASC 606 than we have done so under current guidance.
- We previously recognized revenue from [many/some/a few] of our contracts [in X business unit/Y segment/Z geography] over time by using a percentage of completion model in accordance with ASC 605-35. These contracts will not meet the criteria in ASC 606 for recognizing revenue over time. As a result, we will be required to recognize revenue from those contracts later under ASC 606 than we did under ASC 605-35.
- We previously recognized revenue from [many/some/a few] of our contracts [in X business unit/Y segment/Z geography] by using [the completed contract method under ASC 605-35/a final deliverable model], which resulted in the recognition of revenue only upon completion of the efforts associated with these contracts. In contrast, ASC 606 will require us to recognize revenue from these contracts over time. As a result, revenue from these arrangements will increase in earlier periods.

If an entity chooses to provide tabular information to key stakeholders, including information to mirror the entity's selected transition approach (i.e., either (1) the full retrospective method with restatement of prior periods under ASC 250 or (2) the modified retrospective method), stakeholders will benefit from the ability to understand the overall impact of adoption as well as from any opening adjustments to retained earnings.

In remarks delivered at the 35th annual SEC and Financial Reporting Institute Conference in June 2016, Mr. Bricker further emphasized the importance of transition-period disclosures, noting that the preparation of these disclosures should be subject to effective internal controls and disclosure controls and procedures. Specifically, he stated that "[a]s management completes portions of its implementation plan and develops an assessment of the anticipated impact the standard will have on the company's financial statements, internal and disclosure controls should be designed and implemented to timely identify relevant disclosure content from the implementation assessments and to ensure, where necessary, that appropriately informative disclosure is made." For a discussion of disclosure considerations when an SEC registrant establishes new controls and processes related to the adoption of the new revenue standard, see Section 19.1.2.6.

20.6.2 Predecessor/Successor Audits in the Period of Adoption of a New Accounting Standard

In the year of adoption, entities and auditors need to be aware of the potential impact that an auditor change may have on the entity's adoption approach (i.e., the full retrospective or modified retrospective method).

For example, assume that an entity changes auditors before adopting a new accounting standard and subsequently adopts the new standard by using the full retrospective method. Further, assume that the successor auditor is willing to audit the adjustments needed to reflect the new standard in periods audited by the predecessor. In this scenario, the successor auditor would need to be independent of all of the periods that are being retrospectively restated under the full retrospective method. Assuming that the entity adopts the new revenue standard as of January 1, 2018 (by using the full retrospective method), the successor auditor would need to be independent in years 2016, 2017, and 2018.

Alternatively, if the entity decides to use the modified retrospective method, the predecessor auditor for the prior reporting periods must give its consent to the inclusion of its audit opinion for those historical years that are presented but not restated under the modified retrospective method. If the predecessor auditor gives its consent to the inclusion of its audit opinion for those years, the successor auditor would still need to be able to perform an audit of the cumulative catch-up adjustment to the beginning balance of retained earnings in the year of adoption, which could require an analysis of contracts with customers that began in years before the adoption of the new standard.

Appendix A — Differences Between U.S. GAAP and IFRSs

Although the FASB and IASB standards are nearly fully converged, there are some differences between ASC 606 and IFRS 15, such as those indicated in the following table:

Topic	ASC 606	IFRS 15
Step 1 — the collectibility threshold for contracts	Establishes a *probable* collectibility threshold, meaning likely to occur.[1]	Establishes a *probable* collectibility threshold, meaning more likely than not.[2]
Reversal of impairment losses	An entity cannot reverse an impairment loss on capitalized costs to obtain or fulfill a contract.	An entity is required to reverse an impairment loss on capitalized costs to obtain or fulfill a contract.
Interim disclosures	In addition to those required by ASC 270, an entity must provide interim disclosures about each of the following: • The disaggregation of revenue. • Contract asset and contract liability balances and significant changes in those balances. • The transaction price allocated to the remaining performance obligations.	In addition to those required by IAS 34, an entity must provide interim disclosures about the disaggregation of revenue.
Effective date	*Public entities* — Effective for annual reporting periods beginning after December 15, 2017. *Nonpublic entities* — Allowed a one-year delay.	Effective for annual reporting periods beginning on or after January 1, 2018.
	Early adoption — Allowed for annual reporting periods beginning on or after December 15, 2016. Nonpublic entities can adopt no earlier than public entities.	Early adoption is allowed.
Requirements for nonpublic entities	Applies to nonpublic entities, with some specific relief related to disclosure, transition, and effective date. Refer to Chapter 16 for additional information.	*IFRS for Small* and *Medium-sized Entities* may apply to nonpublic entities that adopt IFRS 15.

[1] As defined in ASC 450.
[2] As defined in IFRS 15 and IAS 37.

After the FASB and IASB issued ASU 2014-09 and IFRS 15, respectively, the boards decided to amend certain aspects of the new revenue standard. In some cases, the amendments retained convergence; in other cases, however, the FASB decided on a solution that differs from the IASB's. The following table outlines some additional differences between ASC 606 and IFRS 15 that have arisen as a result of the amendments:

Topic	ASC 606	IFRS 15
Licensing — determining the nature of an entity's promise (see paragraphs BC51 through BC65 of ASU 2016-10)	An entity's determination of whether a license is a right to use (for which revenue is recognized at a point in time) versus a right to access (for which revenue is recognized over time) is based on its classification of the intellectual property (IP) underlying the license as either functional or symbolic.	An entity's determination of whether a license is a right to use versus a right to access is based on whether the customer can direct the use of, and obtain substantially all of the benefits from, the license at the point in time the license is granted. The customer can direct the use of, and obtain substantially all of the benefits from, the license if the underlying IP is not significantly affected by the entity's ongoing activities.
Licensing — renewals (see paragraphs BC48 through BC50 of ASU 2016-10)	The amendment specifies that a renewal or extension is subject to the "use and benefit" guidance in ASC 606-10-55-58C, the application of which will generally result in revenue recognition at the beginning of the renewal period.	The "use and benefit" guidance does not explicitly refer to renewals; as a result, revenue may be recognized earlier than it would be under U.S. GAAP.
Shipping and handling activities (see paragraphs BC19 through BC25 of ASU 2016-10)	The amendment provides an accounting policy election that permits an entity to account for shipping and handling activities that occur after the customer has obtained control of the related good as a fulfillment expense.	The IASB's new revenue standard does not include a similar election.
Noncash consideration (see paragraphs BC36 through BC43 of ASU 2016-12)	As amended: • The FASB's new revenue standard requires measurement at contract inception. • The guidance on variable consideration applies only to variability resulting from reasons other than the form of the noncash consideration.	IFRS 15 does not: • Prescribe a measurement date. • Clarify when the variable consideration guidance applies.
Presentation of sales (and other similar) taxes (see paragraphs BC29 through BC35 of ASU 2016-12)	The amendment provides an accounting policy election that permits an entity to exclude all sales (and other similar) taxes from the measurement of the transaction price.	IFRS 15 does not include a similar election.

(Table continued)

Topic	ASC 606	IFRS 15
Transition — date of application of the contract modification practical expedient (see paragraphs BC44 through BC48 of ASU 2016-12)	If an entity uses the modified retrospective method of transition and elects to use the contract modification practical expedient, the entity must apply that practical expedient as of the date of initial application of the new revenue standard.	If an entity uses the modified retrospective method of transition and elects to use the contract modification practical expedient, the entity may apply that practical expedient as of either (1) the date of initial application of the new revenue standard or (2) the beginning of the earliest period presented.
Transition — completed contracts (see paragraphs BC49 through BC53 of ASU 2016-12)	• ASU 2016-12 defines a completed contract as "a contract for which all (or substantially all) of the revenue has been recognized under legacy GAAP before the date of initial application." • ASU 2016-12 makes no changes related to the full retrospective method.	• IFRS 15 defines a completed contract as "a contract for which the entity has transferred all of the goods or services identified in accordance with [existing IFRSs]." • For entities that use the full retrospective method of transition, the IASB added a practical expedient that allows them to elect not to restate contracts that are completed as of the beginning of the earliest period presented.

Further, some of the boards' respective amendments to the new revenue standard are generally expected to produce similar outcomes under ASC 606 and IFRS 15 despite differences between the FASB's wording and that of the IASB. The following table provides examples of differently articulated but similar guidance in ASC 606 and IFRS 15, as amended:

Topic	ASC 606	IFRS 15
Collectibility — criterion explanation and examples (see paragraphs BC9 through BC20 of ASU 2016-12)	ASU 2016-12 provides an additional explanation of the collectibility threshold's objective, as well as implementation guidance and examples.	No additional guidance provided.
Collectibility — recognition criterion for contracts that fail step 1 (see paragraphs BC21 through BC28 of ASU 2016-12)	ASU 2016-12 adds a third criterion to allow revenue recognition when a contract fails step 1 (ASC 606-10-25-1).	Additional criterion not provided.
Immaterial goods or services (see paragraphs BC8 through BC18 of ASU 2016-10)	When identifying performance obligations, an entity is not required to assess immaterial items in the context of the contract as promised goods or services.	Overall materiality considerations should be used in the evaluation of items under IFRSs.

(Table continued)

Topic	ASC 606	IFRS 15
Licensing — when to consider the nature of an entity's promise in granting a license (see paragraphs BC66 through BC69 of ASU 2016-10)	ASU 2016-10 contains explicit guidance to indicate that when a bundle of goods or services is determined to be a single performance obligation that includes a license of IP, an entity should apply the license implementation guidance to determine whether revenue related to the performance obligation should be recognized over time (including an appropriate measure of progress) or at a point in time.	Guidance provided is less explicit.
Licensing — contractual restrictions (see paragraphs BC41 through BC47 of ASU 2016-10)	ASU 2016-10 contains explicit guidance to indicate that contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to the customer (e.g., additional rights) should be distinguished from contractual provisions that define attributes of a single promised license (e.g., restrictions of time or geography).	No guidance added to IFRS 15; however, the standard's Basis for Conclusions explains that the license implementation guidance does not override the general model — specifically, the requirements for identifying performance obligations.

Appendix B — Codification Example Index

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Appendix D — Summary of Revenue Implementation Issues Discussed by the TRG to Date

This appendix summarizes issues discussed by the TRG to date, which are organized topically in a manner consistent with their arrangement in this Roadmap. See Appendix E for a chronological listing of the issues discussed and links to additional information.

D.1 Scope (Chapter 3 of the Roadmap)

D.1.1 Fees and Reward Programs Related to Bank-Issued Credit Cards (July 2015 TRG Meeting)

Because banks have accounted for fees and reward programs related to credit cards they issue under ASC 310, questions have arisen about whether such fees and programs would be within the scope of ASC 606 or ASC 310.

TRG members in the United States generally agreed with the following observations and conclusions of the FASB staff:

- The FASB staff noted that all credit card fees are currently accounted for under ASC 310 because they are related to credit lending activities (i.e., akin to loan origination fees). The staff also noted that the new revenue standard does not include consequential amendments to ASC 310. Accordingly, the staff believed that entities would continue to account for services exchanged for credit card fees under ASC 310 rather than ASC 606. However, the staff noted that as an anti-abuse measure, entities need to assess whether credit card fees and services should be accounted for under ASC 606 when the issuance of a credit card appears incidental to the arrangement (e.g., when a card is issued in connection with the transfer of (1) an automobile or (2) asset management services).
- The FASB staff indicated that if an entity concludes that the credit card arrangement is within the scope of ASC 310, the associated reward program would also be within the scope of ASC 310.

TRG members also noted that outcomes under U.S. GAAP may differ from those under IFRSs because of differences between ASC 310 and IFRS 9.

D.1.2 Whether Fixed-Odds Wagering Contracts Are Revenue or Derivative Transactions (November 2015 TRG Meeting)

Partly because the new revenue standard will eliminate the guidance in ASC 924-605 and partly because of an interpretation issued by the IFRIC,[1] stakeholders reporting under U.S. GAAP have questioned whether fixed-odds wagering[2] contracts should be accounted for as revenue transactions (i.e., when or as control is transferred in accordance with the new revenue standard) or as derivatives under ASC 815 (i.e., adjusted to fair value through net income each reporting period).

Many TRG members in the United States did not object to the FASB staff's view that entities should continue to account for fixed-odds wagering contracts as revenue transactions after the new revenue standard becomes effective. However, TRG members expressed concern that the current wording in the new revenue standard does not support the staff's view. Accordingly, TRG members recommended that the Board either (1) clarify its intent through a technical correction to include such contracts within the scope of ASC 606 (by excluding them from the scope of ASC 815) or (2) evaluate further whether its objective was to require entities to account for these contracts under ASC 815.

On May 18, 2016, the FASB issued a proposed ASU on technical corrections to the new revenue standard, which would include in ASC 924 a derivatives guidance scope exception for fixed-odds wagering contracts by adding a new Codification subtopic (ASC 924-815, *Entertainment — Casinos: Derivatives and Hedging*) that would clarify that such contracts are revenue contracts within the scope of ASC 606. The FASB affirmed its decision at the August 31, 2016, board meeting. See also Chapter 19.

D.1.3 Whether Contributions Are Within the Scope of the New Revenue Standard (March 2015 TRG Meeting)

Contributions[3] are not explicitly excluded from the scope of the new revenue standard.[4] As a result, some stakeholders have questioned whether contributions are within the scope of the standard. The FASB staff affirmed its belief that because contributions are nonreciprocal transfers (i.e., they do not involve the transfer of goods or services to a customer), they are outside the scope of the new guidance.

TRG members in the United States generally agreed that nonreciprocal contributions are not within the scope of the new revenue standard; however, TRG members noted that if a not-for-profit entity transfers a good or service for part or all of a contribution (i.e., a reciprocal transfer), such a reciprocal transfer should be accounted for under ASC 606. TRG members in the United States also agreed with FASB board and staff members not to amend ASC 606 to add another scope exception and agreed with a FASB board member's suggestion that the AICPA could evaluate whether to include an interpretive clarification in its nonauthoritative industry guidance.

[1] In 2007, the IFRIC concluded that fixed-odds wagering contracts should be accounted for as derivatives under IAS 39 (or IFRS 9, if an entity is required to adopt it).

[2] Fixed-odds wagers are wagers placed by bettors (i.e., customers) who typically know the odds of winning in gaming activities (e.g., table games, slot machines, keno, bingo, and sports and race betting) at the time the bets are placed with gaming industry entities.

[3] Contributions are defined as nonreciprocal transfers to a not-for-profit entity. They are distinguishable from exchange transactions, which are reciprocal transfers.

[4] This topic applies only to U.S. GAAP because IFRSs do not provide industry-specific guidance for not-for-profit entities. See ASC 958-605 for guidance on revenue recognition by not-for-profit entities under existing U.S. GAAP.

D.1.4 Scope Considerations for Incentive-Based Capital Allocations, Such as Carried Interests (April 2016 FASB-Only TRG Meeting)

Compensation for asset managers commonly consists of both management fees (usually a percentage of assets under management) and incentive-based fees (i.e., fees based on the extent to which a fund's performance exceeds predetermined thresholds). Often, private-equity or real estate fund managers (who may be the general partner and have a small ownership percentage in the fund) will receive incentive-based fees by way of an allocation of capital from a fund's limited partnership interests (commonly referred to as "carried interests").

While Example 25 in the new revenue standard contains implementation guidance that demonstrates how to apply the variable constraint to an asset management contract, the example does not specify "whether the example applies to equity-based arrangements in which the asset manager is compensated for performance-based fees via an equity interest (that is, incentive-based capital allocations such as carried interests)."[5] Consequently, the following views have been expressed by stakeholders on whether carried interests are within the scope of the new revenue standard:

- *View A* — Carried interests are within the scope of the new revenue standard.
- *View B* — Carried interests are outside the scope of the new revenue standard.
- *View C* — An entity's accounting for carried interests may vary in accordance with the nature and substance of the arrangement.

After significant discussion, the TRG did not reach general agreement on whether carried interests in asset management arrangements are within the scope of ASC 606 and thus subject to the new standard's variable constraint guidance. The Board reiterated that its intention was to include these arrangements within the scope of ASC 606 because the Board viewed these incentive-based fees as compensation for services provided (i.e., part of revenue transactions). Many TRG members agreed that the arrangements are within the scope of ASC 606.

However, some TRG members expressed an alternative view that a carried interest could be regarded as an equity arrangement, because it is, in form, an interest in the entity. As a result of this view, those TRG members noted that if the arrangements are considered equity interests outside the scope of ASC 606, questions could arise in a consolidation analysis — specifically, questions related to whether the asset managers should consolidate the funds.

The SEC staff's view is characterized in the meeting minutes (TRG Agenda Paper 55) as follows:

> The SEC staff observer indicated that he anticipates the SEC staff would accept an application of [ASC] 606 for those arrangements. However, the observer noted that there may be a basis for following an ownership model. If an entity were to apply an ownership model, then the SEC staff would expect the full application of the ownership model, including an analysis of the consolidation model under [ASC] 810, the equity method of accounting under [ASC] 323, or other relevant guidance[.]

The minutes of the TRG meeting suggest that the FASB staff does not recommend that the Board undertake standard-setting activity with respect to this topic.

[5] Quoted from paragraph 12 of TRG Agenda Paper 50.

D.1.5 Scope Considerations for Financial Institutions (April 2016 FASB-Only TRG Meeting)

To determine which guidance applies to the fees associated with certain common financial institution transactions, stakeholders have asked the FASB to clarify whether (1) mortgage servicing rights[6] should be accounted for under ASC 606 or ASC 860, (2) deposit-related fees[7] should be accounted for under ASC 405, and (3) fees from financial guarantees[8] should be accounted for under ASC 460 or ASC 815.

D.1.5.1 Mortgage Servicing Rights

The FASB staff noted that assets and liabilities associated with mortgage servicing rights traditionally have been accounted for under ASC 860 and that such practice will not change under the new revenue standard. The TRG generally agreed that servicing arrangements that are within the scope of ASC 860 are not within the scope of ASC 606 and that ASC 860 addresses both the initial recognition and subsequent measurement of mortgage servicing assets and liabilities. In addition, the TRG generally agreed that since the subsequent measurement of the mortgage servicing assets and liabilities depends on the cash flows associated with the mortgage servicing rights, ASC 860 should be used to account for such cash flows.[9]

D.1.5.2 Deposit-Related Fees

The TRG generally agreed that entities would account for revenue from deposit-related fees in accordance with ASC 606 after they adopt the new standard. Financial institutions would continue to (1) record liabilities for customer deposits because the deposits meet the definition of a liability and (2) account for customer deposits in accordance with ASC 405. However, because ASC 405 does not contain specific guidance on how to account for deposit fees, financial institutions should apply ASC 606 for deposit-related fees (i.e., in manner similar to the application of existing SEC revenue guidance by some financial institutions to account for deposit-related fees). The FASB staff suggested that implementation concerns raised by some stakeholders could be alleviated by careful analysis of the contract terms between the financial institution and the customer. Because customers generally have the right to cancel their depository arrangement at any time, the FASB staff believes that most contracts would be short term (e.g., day to day or minute to minute). As a result, revenue recognition patterns would be similar regardless of the number of performance obligations identified, and any changes to current practice would most likely be insignificant.

D.1.5.3 Fees Related to Financial Guarantees

The TRG generally agreed that fees related to financial guarantees should be accounted for in accordance with either ASC 460 or ASC 815. The basis for the TRG's view is partly due to its belief that "the fee would not be received unless the guarantee was made, and the guarantee liability is typically reduced (by a credit to earnings) as the guarantor is released from the risk under the guarantee."[10]

[6] After originating a loan (or selling an originated loan but retaining rights to service the loan), a financial institution may perform services that include communicating with the borrower; collecting payments for interest, principal, and other escrow amounts; and performing recordkeeping activities.

[7] Deposit-related fees are those that a financial institution charges to a customer for amounts on deposit with the financial institution. Fees may be charged to give customers access their funds and to cover other activities, including recordkeeping and reporting. In addition, fees may be transaction-based (such as fees to withdraw funds through an automated teller machine) or may not be transaction-based (such as account maintenance fees).

[8] Fees charged by a financial institution to a borrower on a loan, for example, in return for the financial institution's acting as a third-party guarantor on the borrower's debt.

[9] Paragraph 11 of TRG Agenda Paper 52 notes that some entities believe that there is a close link between ASC 860's asset and liability remeasurement requirements and the collection of servicing fees (which gives rise to mortgage servicing income).

[10] Quoted from paragraph 61 of TRG Agenda Paper 52.

Further, ASC 460 or ASC 815 provides a framework that addresses both initial recognition and subsequent measurement of the guarantee. In addition, the FASB staff cited paragraph BC61 of ASU 2014-09 as further evidence of the Board's intent to exclude guarantees from the scope of ASC 606. The FASB staff also noted that it may suggest technical corrections to the Board to clarify the scope for fees from financial guarantees in ASC 942-825-50-2 and ASC 310-10-60-4. See also Chapter 19.

D.2 Step 1 — Identify the Contract With the Customer (Chapter 4 of the Roadmap)

D.2.1 Contract Enforceability and Termination Clauses (October 2014 and November 2015 TRG Meetings)

TRG members generally agreed with the staffs' examples and conclusions demonstrating that the duration of a contract is predicated on the contract's enforceable rights and obligations. Accordingly, regardless of whether one or both parties have the right to terminate the contract, an entity would need to evaluate the nature of the termination provisions, including whether they are substantive. For example, an entity would assess factors such as (1) whether the terminating party is required to pay compensation, (2) the amount of such compensation, and (3) the reason for the compensation (i.e., whether the compensation is in addition to amounts due for goods and services already delivered).

TRG members acknowledged that the determination of whether a termination provision is substantive will require judgment and would be evaluated both quantitatively and qualitatively. Some offered that data about the frequency of contract terminations may be useful in such a determination (i.e., a high frequency of payments made to terminate contracts may suggest that the termination provision is not substantive).

Further, TRG members generally agreed that when the term of a contract is less than the contract's stated term (e.g., when a 12-month contract is determined to be a month-to-month contract rather than for a year, indicating that the penalty is not substantive), an entity would have to (1) reassess the allocation of the transaction price, (2) include the termination penalty in the transaction price (subject to the constraint on variable consideration, if appropriate), and (3) assess whether the termination provisions provide the customer with a material right (similarly to how the entity would assess renewal options in a contract).

D.2.2 Collectibility (January 2015 TRG Meeting)

In discussing issues identified by stakeholders on the collectibility assessment, TRG members generally agreed that:

- When collectibility is probable for a portfolio of contracts, the expected amount should be recognized as revenue, and the uncollectible amount should be recorded as an impairment loss in accordance with ASC 310 or IFRS 9.
- In determining when to reassess collectibility, an entity needs to exercise judgment on the basis of the facts and circumstances.
- The new revenue standard clearly prohibits entities from recognizing revenue when collectibility is not probable despite any nonrefundable cash payments that may have been received. Essentially, cash-based accounting will no longer be permitted under the new revenue standard.
- An assessment of whether a price adjustment is due to collectibility (i.e., credit) or a price concession is complex but can be performed in practice.

On May 9, 2016, the FASB issued ASU 2016-12, which amends certain aspects of the new revenue standard. ASU 2016-12 clarifies the objective of the entity's collectibility assessment and contains new guidance on when an entity would recognize as revenue consideration it receives if the entity concludes that collectibility is not probable. For additional information, see Chapter 4.

D.3 Step 2 — Identify Performance Obligations (Chapter 5 of the Roadmap)

D.3.1 Immaterial Goods or Services (January 2015 TRG Meeting)

Paragraph BC87 of ASU 2014-09 indicates that before an entity can identify performance obligations in a contract with its customers, it must first identify all promised goods or services in the contract. Paragraph BC89 notes that the FASB and IASB "decided that all goods or services promised to a customer as a result of a contract give rise to performance obligations." Further, paragraph BC90 states that the boards "decided not to exempt an entity from accounting for performance obligations that the entity might regard as being perfunctory or inconsequential."

TRG members discussed various options, including whether to (1) specifically address "perfunctory or inconsequential" items in the text of the new revenue standard, (2) delete the wording from paragraph BC90 (as quoted above), and (3) add other implementation guidance.

While some TRG members discussed the potential need to add the concept of "inconsequential or perfunctory" to the new revenue standard, there appeared to be general agreement that such an addition would not be necessary. Further, most TRG members believed that the evaluation of promised goods or services in a contract would lead to about the same number of deliverables that are identified today.

On April 14, 2016, the FASB issued ASU 2016-10, which amends certain aspects of the new revenue standard, specifically the guidance on identifying performance obligations and the implementation guidance on licensing. ASU 2016-10 states that an entity "is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer." In addition, the ASU indicates that an entity should consider materiality of items or activities only at the contract level (as opposed to aggregating such items and performing an assessment at the financial statement level). For additional information, see Chapter 5.

D.3.2 Stand-Ready Obligations (January 2015 TRG Meeting)

The new revenue standard notes that promises in a contract with a customer may be explicit or implicit and lists examples of promised goods or services. One such example is "[p]roviding a service of standing ready to provide goods or services . . . or of making goods or services available for a customer to use as and when the customer decides,"[11] referred to as stand-ready obligations.

Stakeholders have identified the following broad types of promises or arrangements that may constitute stand-ready obligations:

- *Type A* — The obligation to deliver goods or services is within the entity's control, but additional development of the goods, services, or intellectual property (IP) is required.
- *Type B* — The obligation to deliver goods or services is outside both the entity's and the customer's control.

[11] ASC 606-10-25-18(e).

- *Type C* — The obligation to deliver goods or services is solely within the customer's control.
- *Type D* — The obligation is a promise to make goods or services available to the customer continuously over the contractual period.

Because the new revenue standard provides an example of Type D arrangements but not others, questions have arisen regarding the identification of other stand-ready obligations (i.e., Types A through C) and how to appropriately measure progress toward completion of delivering the promised goods or services. Specifically, views differ on (1) what constitutes the nature of the promise in the aforementioned arrangements (e.g., whether it is the act of standing ready or the actual delivery of the goods or services to the customer) and (2) the methods used to measure progress toward the complete satisfaction of a stand-ready obligation (e.g., a time-based, input, or output method).

TRG members generally agreed that (1) the principle in the new revenue standard requires an entity to understand the nature of the promise, (2) entities should exercise judgment to determine an appropriate measure of progress toward complete satisfaction of a stand-ready performance obligation because the new revenue standard does not allow entities to automatically conclude that recording revenue on a straight-line basis is appropriate, and (3) TRG Agenda Paper 16 helps illustrate considerations for making these judgments.

In addition, some TRG members questioned whether paragraph 14 of TRG Agenda Paper 16 could change practice related to the identification of specified upgrades in software arrangements. The FASB staff clarified that its intention for including paragraph 14 was not to change practice but to note that an entity should evaluate additional promises in a contract with a customer (regardless of whether such promises involve specified upgrades or other specified goods or services).

D.3.3 Distinct in the Context of the Contract (October 2014 TRG Meeting)

ASC 606-10-25-21 lists three factors (not all-inclusive) to help entities assess whether goods or services are distinct in the context of the contract.

Stakeholder views differ on whether (and, if so, to what extent) the existence of factors such as a customized or complex design, an entity's learning curve to produce the contractual goods or services, or the customer's motivation for purchasing the goods or services affects whether goods or services are distinct in the context of the contract.

While TRG members generally agreed that such factors are not individually determinative of whether goods or services are distinct in the context of the contract, there were inconsistent views on whether the evaluation should be performed (1) from the customer's perspective, (2) from the entity's perspective, or (3) only on the basis of the contract. Some TRG members believed that the entity should consider what items the customer has been promised and whether the promised items will be integrated in some way. For example, many TRG members agreed that an entity would need to evaluate the impact of design services it performs in determining the performance obligations under a contract (e.g., if the customer obtains control of the rights to the manufacturing process developed by the entity).

The TRG also discussed how the entity's knowledge of its customer's intended use for the goods or services would affect the determination of whether the goods or services were highly interrelated. Many TRG members expressed the view that an entity should consider whether the goods or services could fulfill their intended purpose on a stand-alone basis or whether they are inseparable because they affect the ability of the customer to use the combined output for which it has contracted.

ASU 2016-10 refines the separation criteria for assessing whether promised goods and services are distinct, specifically the "separately identifiable" principle (the "distinct within the context of the contract" criterion) and supporting factors. To further clarify this principle and the supporting factors, the ASU adds six new examples and amends other examples to demonstrate the application of the guidance to several different industries and fact patterns. For further information, see Chapter 5.

D.3.4 Series of Distinct Goods or Services (March 2015 TRG Meeting)

To promote simplicity and consistency in application,[12] the new revenue standard includes the concept of a series of distinct goods or services that are substantially the same and have the same pattern of transfer (the "series provision").[13] Accordingly, goods and services constitute a single performance obligation if (1) they are "bundled" together because they are not distinct or (2) they are distinct but meet the criteria that require the entity to account for them as a series (and thus as a single performance obligation).

TRG members generally agreed that:

- Goods or services do not need to be transferred consecutively (i.e., an entity should look to the series provision criteria in ASC 606-10-25-15 to determine whether the goods or services are a series of distinct goods or services for which the entity is not explicitly required to identify a consecutive pattern of performance). Further, while the term "consecutively" is used in the Basis for Conclusions of ASU 2014-09, the FASB and IASB staffs noted that they "do not think whether or not the pattern of performance is consecutive is determinative [of] whether the series provision applies."[14]
- The accounting result for the series of distinct goods or services as a single performance obligation does not need to be "substantially the same"[15] as if each underlying good or service were accounted for as a separate performance obligation. Further, the FASB and IASB staffs stated that "[s]uch a requirement would almost certainly make it more difficult for entities to meet the requirement, and since the series provision is not optional, it likely would *require* entities to undertake a 'with and without' type analysis in a large number of circumstances to prove whether the series provision applies or not."[16]

D.3.5 Application of the Series Provision and Allocation of Variable Consideration (July 2015 TRG Meeting)

Stakeholders have raised the following questions related to whether performance obligations in long-term contracts meet the criteria to be accounted for under the series guidance:

- In applying the series guidance, how should entities determine whether distinct goods or services are substantially the same?
- If a contract provides for a fixed price per unit of output but the quantity of outputs is undefined, is the consideration variable?
- Should variable consideration be allocated on the basis of the relative stand-alone selling price of each performance obligation (or distinct good or service)?

[12] Paragraph BC113 of ASU 2014-09.
[13] ASC 606-10-25-14 and 25-15.
[14] Quoted from paragraph 14 of TRG Agenda Paper 27.
[15] Quoted from paragraph 20 of TRG Agenda Paper 27.
[16] See footnote 15.

TRG members discussed four examples presented by the FASB and IASB staffs in TRG Agenda Paper 39 that illustrate the application of the staffs' framework for determining whether an entity is required to apply the series guidance. The staffs' analysis of one such example in relation to steps 2, 3, 4, and 5 of the new revenue standard is summarized below.

Example and Analysis

A provider of hotel management services enters into a 20-year contract to manage a customer's properties. The service provider receives consideration based on 1 percent of monthly rental revenue, reimbursement of labor costs incurred, and an annual incentive fee of 8 percent of gross operating profit.

Step 2 — Identifying a Performance Obligation

An entity would need to determine (1) the nature of the services promised to the customer and (2) whether the promised services are distinct and substantially the same. The nature of the promised service in the example was believed to be a single integrated management service comprising distinct activities (e.g., management of hotel employees, accounting services, training, and procurement). Day-to-day activities do not need to be identical to be substantially the same. Therefore, while these activities could vary from day to day, the nature of the service is one that provides an integrated management service and represents a single performance obligation instead of multiple performance obligations (for each underlying activity or different combinations of activities).

Step 3 — Determining the Transaction Price

A contractual agreement to provide an unknown quantity of services throughout the contract term contains variable consideration (i.e., total consideration is contingent on the quantity of services provided to the customer). In the example, the annual incentive fee and monthly revenue rental fee constitute variable consideration since the amount is not fixed. Further, reimbursable labor hours are not fixed given the nature of the service and therefore represent variable consideration.

Step 4 — Allocating the Transaction Price to the Performance Obligations

Allocating variable consideration to each month could meet the allocation objective because the amount corresponds to the value provided to the customer each month. Similarly, the FASB and IASB staffs noted that the variable consideration related to the reimbursement of labor costs could be allocated to each day (although it may be allocated on a monthly basis for practical reasons). Further, the staffs believed that the annual incentive fee could reflect the value delivered to the customer and therefore could be allocated to the annual period.

Step 5 — Recognizing Revenue as the Entity Satisfies the Performance Obligation

The provider of hotel management services would recognize the monthly variable fee and reimbursement of labor costs as the monthly services are provided. Further, the entity would estimate (subject to the constraint for variable consideration) the annual incentive fee and recognize the fee over the annual period on the basis of the common measure of progress.

The TRG generally agreed with the FASB and IASB staffs' conclusions and acknowledged that the staffs' examples and analysis in TRG Agenda Paper 39 provide a framework for applying the guidance. Specifically, TRG members generally agreed that:

- An entity's first step is to determine the nature of its promise of providing services to its customer.
- Consideration is variable when the contractual rate per unit of output is fixed but the quantity (units of output) is undefined.
- The use of stand-alone selling prices to allocate variable consideration to a distinct good or service is an acceptable method but is not required to meet the allocation objective in ASC 606-10-32-28.

TRG members also noted that service contracts can be considerably more complex in practice. Further, it was noted that the revenue recognition pattern in each of the examples discussed does not represent multiple-attribution recognition (for additional information, see Section D.6.3) but instead is the result of step 4's allocation process.

ASU 2016-10 adds Example 12A[17] to the implementation guidance of the new revenue standard to illustrate the application of the series provision and allocation of variable consideration. Example 12A is similar to the hotel management example above.

D.3.6 Customer Options for Additional Goods and Services (November 2015 TRG Meeting)

D.3.6.1 Distinguishing Customer Options From Variable Consideration

TRG members generally agreed with the FASB and IASB staffs' framework under which an entity would perform an evaluation of the nature of its promises in a contract with a customer. Such evaluation would include a careful assessment of the enforceable rights and obligations in the present contract (not future contracts). That is, there is a distinction between (1) customer options and (2) uncertainty that is accounted for as variable consideration. Customer options are predicated on a separate customer action (namely, the customer's decision to exercise the option), which would not be embodied in the present contract; unless an option is a material right, such options would not factor into the accounting for the present contract. Uncertainty is accounted for as variable consideration when the entity has enforceable rights and obligations under a present contract to provide goods or services without an additional customer decision.

D.3.6.2 When Optional Goods and Services Would Be Considered Separate Performance Obligations

The TRG generally agreed that enforceable rights and obligations in a contract are only those for which the entity has legal rights and obligations under the contract and would not take economic or other penalties into account (e.g., (1) economic compulsion or (2) exclusivity because the entity is the sole provider of the goods or services, which may make the future deliverables highly probable of occurring). Accordingly, optional goods and services would be accounted for in the current contract if they represent material rights or are considered variable consideration because the entity has legal rights and obligations under the contract.

D.3.7 Accounting for Material Rights (October 2014, January 2015, and March 2015 TRG Meetings; April 2016 FASB-Only TRG Meeting)

D.3.7.1 Need to Evaluate Quantitative and Qualitative Factors in Assessing Customer Options for Material Rights (October 2014 TRG Meeting)

TRG members generally agreed that in determining whether an option for future goods or services is a material right, an entity should (1) consider factors outside the current transaction (e.g., the current class of customer[18]) and (2) assess both quantitative and qualitative factors. Further, TRG members noted that an entity should also evaluate incentives and programs to understand whether they are customer options designed to influence customer behavior (i.e., an entity should consider incentives

[17] ASC 606-10-55-157B through 55-157E.

[18] ASC 606-10-25-2 and ASC 606-10-55-42.

and programs from the customer's perspective) because this could be an indicator that an option is a material right.

For example, regarding certain offers, such as buy three and get one free, TRG members noted that the quantities involved are less important than the fact that an entity would be "giving away" future sales in such cases. While not determinative, such an indicator may lead an entity to conclude that a customer option is a material right.

D.3.7.2 Accumulation Features (October 2014 TRG Meeting)

TRG members also discussed loyalty programs that have an accumulation feature. Some TRG members noted the belief that through the presence of an accumulation feature in a loyalty program, the entity gives its customers a material right. Others, however, indicated that the accumulation feature is not a determinative factor that would automatically lead an entity to conclude that the entity grants its customers a material right. Rather, these TRG members noted that if an accumulation feature is present, an entity would be required to evaluate the program.

We believe that the existence of an accumulation feature in a loyalty program is a strong indicator of a material right, to which an entity would need to allocate a portion of the current contract's transaction price.

D.3.7.3 Accounting for a Customer's Exercise of a Material Right (January 2015 and March 2015 TRG Meetings)

TRG members generally preferred the view that an entity would account for the exercise of a material right as a change in the contract's transaction price[19] (i.e., a continuation of the contract, whereby the additional consideration would be allocated to the material right). However, the TRG also believed that it would be acceptable for an entity to account for the exercise of a material right as a contract modification[20] (which may require reallocation of consideration between existing and future performance obligations).

D.3.7.4 How to Evaluate a Material Right for the Existence of a Significant Financing Component (January 2015 and March 2015 TRG Meetings)

TRG members indicated that they would generally view a customer's exercise of a material right as a continuation of the initial contract. However, they could also understand why others might view such an exercise as a contract modification or variable consideration depending on the facts and circumstances. TRG members also noted that while the determination of whether there is a significant financing component (associated with the material right) depends on the facts and circumstances, entities would need to evaluate material rights for the existence of significant financing components in a manner similar to how they would evaluate any other performance obligation. See Section D.4.6 below for additional TRG views.

[19] ASC 606-10-32-42 through 32-45.
[20] ASC 606-10-25-10 through 25-13.

D.3.7.5 Determining the Period Over Which an Entity Should Recognize a Nonrefundable Up-Front Fee (January 2015 and March 2015 TRG Meetings)

The TRG generally agreed that a nonrefundable up-front fee (e.g., a one-time activation fee in a month-to-month service contract under which the entity has not committed to future pricing)[21] should be recognized over the contract period if the entity concludes that the fee does not provide a material right. Conversely, if the nonrefundable up-front fee provides the customer with a material right, the fee should be recognized over the expected service period to which the material right relates. An entity should consider both qualitative and quantitative factors to determine whether a nonrefundable up-front fee provides the customer with a material right.

D.3.7.6 Considering the Class of Customer in the Evaluation of Whether a Customer Option Gives Rise to a Material Right (April 2016 FASB-Only TRG Meeting)

Stakeholder views have differed regarding how the class of customer should be considered in an entity's evaluation of whether a customer option gives rise to a material right.

TRG members debated the application of concepts in the framework the staff used to analyze the examples in TRG Agenda Paper 54 but did not reach general agreement on (1) how or when to consider past transactions in determining the class of customer and (2) how the class of customer should be evaluated in the determination of the stand-alone selling price of an optional good or service.

A few TRG members maintained that discounts or status achieved through past transactions is akin to accumulating features in loyalty programs (and that such features therefore represent material rights). However, others indicated that these programs represent marketing inducements (i.e., discounts) for future transactions that should be evaluated in relation to those offered to other similar customers or potential customers (e.g., other high-volume customers or potential high-volume customers). The TRG members who viewed the programs as marketing inducements believed that considering a customer's past transactions, among other factors, is appropriate in the evaluation of whether a good or service being offered to the customer reflects the stand-alone selling price for that class of customer in accordance with ASC 606-10-55-42 (particularly for entities that have limited alternative sources of information available upon which to establish a customer's class). Further, these TRG members focused on the facts that (1) similar discounts on future transactions (like those provided in the form of benefits and other offers in status programs for no additional fees) may be given to other customers who did not make or have the same level of prior purchases with the entity and (2) such discounts may be provided at the stand-alone selling price for that class of customer (i.e., the good or service is not priced at a discount that is incremental to the range of discounts typically offered to that class of customer and therefore do not represent a material right).

Because general agreement was not reached, certain Board members recommended that the staff perform additional outreach, particularly with preparers in the travel and entertainment industries and with procurement personnel in large organizations, to understand how discounts and tier status programs are negotiated and structured. After soliciting additional input, the FASB staff will determine next steps, if any.

[21] This issue was also discussed at the October 2014 TRG meeting. For more information, see Deloitte's October 2014 *TRG Snapshot*.

D.3.8 Warranties (March 2015 TRG Meeting)

The new revenue standard provides guidance on when an entity should account for a warranty as a performance obligation (e.g., if a customer has a choice to purchase a warranty or the warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications). If the warranty is a performance obligation, the entity would account for the warranty by allocating a portion of the transaction price to that performance obligation.[22] The guidance includes three factors that the entity would consider in making such a determination: (1) whether the warranty is required by law, (2) the length of the coverage period, and (3) the nature of the tasks that are promised.[23]

Questions continually arise about how an entity would determine whether a product warranty that is not separately priced is a performance obligation (i.e., whether the warranty represents a service rather than a guarantee of the product's intended functionality). For illustrative purposes, TRG members discussed an example in which a luggage company provides a lifetime warranty to repair any damage to the luggage free of charge and noted that such a warranty would be a separate performance obligation because the company agreed to fix repairs for any damage (i.e., repairs extend beyond those that fix defects preventing the luggage from functioning as intended).

TRG members generally agreed with the conclusion that the warranty in the luggage example would represent a separate performance obligation but that it "illustrates a relatively [straightforward] set of facts and circumstances that demonstrate an instance of when a warranty provides a service."[24] However, the conclusion for other warranty arrangements may be less clear. Accordingly, an entity will need to assess the substance of the promises in a warranty arrangement and exercise judgment on the basis of the entity's specific facts and circumstances.

In addition, while the duration of the warranty (e.g., the lifetime warranty in the luggage company example discussed) may be an indicator of whether a warranty is a separate performance obligation, it is not determinative.

D.4 Step 3 — Determine the Transaction Price (Chapter 6 of the Roadmap)

D.4.1 Amounts Billed to Customers — Gross Versus Net (July 2014 TRG Meeting)

In determining the transaction price under the new revenue standard, an entity should exclude "amounts collected on behalf of third parties" (e.g., some sales taxes). In many scenarios, however, it may be unclear whether amounts billed to an entity's customer (e.g., shipping and handling fees, out-of-pocket expenses, taxes and other assessments remitted to governmental authorities) are collected on behalf of third parties. Consequently, there are inconsistent views on whether such amounts should be presented as revenue or as reductions of costs in accordance with the new revenue standard.

The TRG discussion centered primarily on taxes and shipping and handling costs. One TRG member noted that the new revenue standard's definition of transaction price is clear and that an entity would therefore record amounts gross unless the entity (1) arranges shipping on behalf of the customer in accordance with the customer's specifications or (2) the tax is levied on the customer. In each case, the entity is only responsible for collecting and remitting fees to third parties. TRG members acknowledged

[22] ASC 606-10-32-28 through 32-41.
[23] ASC 606-10-55-33.
[24] Quoted from paragraph 28 of TRG Agenda Paper 29.

that an entity would most likely need to assess whether it is acting as a principal or an agent to determine how to present amounts billed and collected on behalf of third parties.

Regarding taxes, TRG members noted that the new revenue standard would require entities to evaluate every type of tax (e.g., sales, income, excise) in every tax jurisdiction (i.e., in every local, state, and federal jurisdiction in each country in which the entity has contracts with customers). Many questioned whether such an exercise is practical or whether it was intended by the boards.

On May 9, 2016, as noted in Section D.2.2 above, the FASB issued ASU 2016-12, which amends certain aspects of the new revenue standard. The ASU permits entities to exclude from the transaction price all sales taxes that are assessed by a governmental authority and that are "imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes)." However, such an accounting policy election does not apply to taxes assessed on "an entity's total gross receipts or imposed during the inventory procurement process." An entity that elects to exclude sales taxes is required to provide the accounting policy disclosures in ASC 235-10-50-1 through 50-6. For additional information, see Chapter 6.

D.4.2 Variable Consideration (January 2015 TRG Meeting)

Stakeholders have questioned (1) when to recognize variable consideration (specifically, consideration payable to a customer) and (2) the unit of account for recognizing variable consideration (i.e., whether variable consideration, such as consideration payable to a customer, should be assessed at the contract level or the performance obligation level).

TRG members generally agreed with the FASB and IASB staffs' view[25] that the reversal of revenue from variable consideration or consideration payable to a customer "should be made at the *earlier* of the date that there is a change in the transaction price in accordance with [ASC 606-10-32-25] or the date at which the consideration payable to a customer is promised in accordance with [ASC 606-10-32-27]." However, certain TRG members noted that it is difficult to support such a view on the basis of the wording in the new revenue standard.

In addition, TRG members also generally agreed with the staffs' view that the constraint on variable consideration should be applied at the contract level because the contract is the unit of account for determining the transaction price.

D.4.3 Consideration Payable to a Customer (January 2015, March 2015, and July 2015 TRG Meetings)

Although the new revenue standard's variable consideration guidance would arguably apply to consideration payable to a customer if such consideration is variable, some stakeholders believe that a requirement to include variable consideration payable to a customer in the transaction price may be inconsistent with the requirement to delay the recognition of consideration payable to a customer until the entity pays or promises to pay.

[25] As expressed in paragraph 20 of TRG Agenda Paper 14.

In July 2015, the TRG noted its general agreement with the FASB and IASB staffs' conclusions on the following three issues raised by stakeholders:

- Assessing which payments to a customer are within the scope of the guidance on consideration payable to a customer.
- Determining who constitutes an entity's customer.
- Determining the timing of recognition of consideration payable to a customer.

In doing so, the TRG generally agreed that the principle in the new revenue standard is appropriate (i.e., that the transaction price should reflect an entity's expectation of the amount of consideration to which it would be entitled).

D.4.3.1 Assessing Which Payments to a Customer Are Within the Scope of the Guidance on Consideration Payable to a Customer

The TRG considered the following views:

- An entity should assess **all** consideration payable (broadly, all payments) to a customer.
- An entity should assess only payments within the current contract (or combined contracts, if the new revenue standard's contract combination requirements are met).

The TRG concluded that an entity should not be required to strictly apply either of these views. Instead, a reasonable application that considers both views should lead to an appropriate outcome.

Further, the TRG concluded that in effect, an entity should evaluate a payment to a customer (or to a customer's customer) — particularly when no goods or services have been transferred — to determine the commercial substance of the payment and whether the payment is linked (economically) to a revenue contract with the customer.

D.4.3.2 Determining Who Constitutes an Entity's Customer

The TRG concluded that an entity's customers include those in the distribution chain and might include a customer's customers that extend beyond those in the distribution chain. In addition, a contractual obligation to provide consideration to a customer's customer (e.g., beyond the distribution chain) would be considered a payment to a customer.

D.4.3.3 Determining the Timing of Recognition of Consideration Payable to a Customer

The TRG concluded that the variable consideration guidance under the new revenue standard does not conflict with the standard's guidance on consideration payable to a customer. In addition, the TRG concluded that if the consideration payable to a customer is variable, the guidance on variable consideration should be applied. Conversely, if such consideration is not variable, the guidance on consideration payable to a customer is applicable.

D.4.4 Portfolio Practical Expedient and Application of the Variable Consideration Constraint (July 2015 TRG Meeting)

When an entity applies the expected-value method in estimating variable consideration, it may consider evidence from similar contracts to form its estimate of expected value. In a manner consistent with the overall objective of the new revenue standard, an entity is also permitted to use a portfolio approach as a practical expedient to account for a group of contracts with similar characteristics rather than account for each contract individually. However, an entity may only apply the practical expedient if it does not expect the results to be materially different from applying the guidance to individual contracts.[26]

Stakeholders have questioned whether:

- The evaluation of evidence from similar contracts would mean that an entity is applying the portfolio practical expedient (and would therefore need to meet the condition of reasonably expecting that the results would not differ materially).
- A transaction price estimated under the expected-value approach can be an amount that is not a possible outcome for an individual contract.

TRG members generally agreed with the FASB and IASB staffs' view that an entity is not necessarily applying the portfolio practical expedient when it considers evidence from similar contracts to develop an estimate under the expected-value method.

In addition, TRG members generally agreed that the transaction price is not automatically reduced by the constraint on variable consideration (i.e., the transaction price may be an amount that is not one of the possible outcomes). However, an entity must still consider the constraint on variable consideration when determining the transaction price.

D.4.5 Noncash Consideration (January 2015 TRG Meeting)

Stakeholders have noted that there are different interpretations regarding when noncash consideration should be measured and that the measurement date for noncash consideration has been variously viewed as (1) the time of contract inception, (2) the time at which the noncash consideration is received (or is receivable), and (3) the earlier of when the noncash consideration is received (or is receivable) or when the related performance obligation is satisfied (or as the performance obligation is satisfied, if satisfied over time).

In addition, stakeholders have indicated that it is unclear from the new revenue standard:

- How to apply the guidance on the inclusion of variable consideration in the transaction price when variability in fair value is attributable to both the form of consideration (e.g., changes in the share price of publicly traded shares of stock received as noncash consideration) and reasons other than the form of consideration (e.g., the number of shares of publicly traded stock that can be given as noncash consideration may change).
- How to apply the constraint to transactions in which variability in the fair value of noncash consideration is attributable to both the form of consideration and reasons other than the form of consideration.

The TRG did not reach general agreement on how the new revenue standard should be applied to address the implementation issues noted. As a result, TRG members noted that additional clarification would be helpful.

[26] ASC 606-10-10-4.

ASU 2016-12 clarifies that an entity's calculation of the transaction price for contracts containing noncash consideration would include the fair value of the noncash consideration to be received as of the contract inception date. Further, subsequent changes in the fair value of noncash consideration after contract inception would be included in the transaction price as variable consideration (subject to the variable consideration constraint) only if the fair value varies for reasons other than its form. For additional information, see Chapter 6.

D.4.6 Significant Financing Components (January 2015 and March 2015 TRG Meetings)

TRG members discussed six implementation issues raised by stakeholders and considered by the FASB and IASB staffs regarding significant financing components. These issues, on which TRG members generally agreed with the staffs' views, are highlighted below.

D.4.6.1 How Broadly to Interpret the Factor in ASC 606-10-32-17(c)[27]

The FASB and IASB staffs noted two prevailing views on interpreting the factor in ASC 606-10-32-17(c):

- Interpret the factor narrowly (i.e., very few reasons would be supportable).
- Interpret the factor more broadly to require an entity to consider the intent of the payment terms (i.e., whether the terms were intended as financing or for other reasons, such as customer convenience, retainer fees, and perceived value by the customer).

TRG members generally agreed with the staffs' conclusion that a reasonable interpretation is most likely something in between these views. In addition, TRG members agreed with the staffs' view that the guidance should not contain a rebuttable presumption that an entity would need to overcome (e.g., regarding the existence or nonexistence of a significant financing component); rather, an entity should be allowed to use judgment to evaluate the facts and circumstances of a transaction.

D.4.6.2 How to Apply the Guidance When the Promised Consideration Is Equal to the Cash Selling Price

TRG members generally agreed with the staffs' view that an entity should not automatically presume that no significant financing component exists if the list price, cash selling price, and promised consideration are the same. Further, they generally shared the staffs' view that a difference in those amounts does not create a presumption that a significant financing component exists; rather, it would require an evaluation.

D.4.6.3 Whether an Entity Can Account for Financing Components That Are Not Significant

TRG members generally agreed with the staffs' conclusion that the new revenue standard neither requires entities to account for insignificant financing components nor precludes them from doing so.

[27] The guidance states that there is no significant financing component when the "difference between the promised consideration and the cash selling price of the good or service (as described in [ASC 606-10-32-16]) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract."

D.4.6.4 Whether the Practical Expedient[28] Can Be Applied When There Is a Single Payment Stream for Multiple Performance Obligations

The staffs cited an example of a two-year customer contract under which an entity delivers a device and provides a service. There are two alternative views on determining whether the practical expedient applies in this situation (i.e., determining the period between the transfer of goods or services and the receipt of payment). Under "View A," an entity would allocate the monthly consideration only to the first item delivered (i.e., the device in the example, which would be delivered at contract inception). In this situation, because the timing of the transfer of the goods and services and receipt of the customer's payment is less than one year (i.e., monthly revenue was allocated to the device), the entity could apply the practical expedient. Conversely, under "View B," an entity would proportionately allocate the monthly consideration to the device and services. Use of the practical expedient in this situation would not be permitted because the period between the transfer of goods and services (collectively) and the receipt of payment is greater than a year (i.e., two years). For the example discussed, the staffs indicated that View B is appropriate because they believed that View A did not appropriately reflect the economics of the transaction. Further, the staffs acknowledged, and TRG members generally agreed with the staffs, that assessing whether an entity can apply the practical expedient when there is a single payment stream for multiple performance obligations may be complex and will require judgment on the basis of the facts and circumstances.

D.4.6.5 How to Calculate Interest for a Significant Financing Component

The staffs noted, and TRG members generally agreed, that the new revenue standard does not explicitly address subsequent measurement, but entities reporting under U.S. GAAP and IFRSs should apply the guidance in ASC 835-30 and IFRS 9, respectively.

D.4.6.6 How to Apply the Significant Financing Component Guidance for Contracts With Multiple Performance Obligations

TRG members generally agreed with the staffs' observation that an entity will need to use judgment when attributing a significant financing component to one or more performance obligations because it may not be possible to determine that a significant financing component is specifically related to one (or some) of the performance obligations.

D.4.7 Accounting for Restocking Fees and Related Costs (July 2015 TRG Meeting)

Stakeholders have raised questions regarding the appropriate accounting for restocking fees collected from customers and restocking costs (e.g., estimated shipping or repackaging) for expected returns.

The TRG generally agreed with the FASB and IASB staffs' view that an entity should include restocking fees for expected returns as part of the transaction price when control is transferred. In addition, the staffs believed that a returned product subject to a restocking fee should be accounted for in a manner similar to how an entity would account for a partial return right (i.e., the restocking fee should be included in the transaction price if the entity is entitled to that amount).

[28] ASC 606-10-32-18 states, "As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less."

With regard to restocking costs, the TRG generally agreed with the staffs' view that an entity should accrue restocking costs upon transfer of control. This view is supported by the guidance in ASC 606-10-55-27, which indicates that an entity should recognize an asset for the entity's right to recover returned products by referring to the former carrying amount and reducing it by the expected costs to recover the products.

D.5 Step 4 — Allocate the Transaction Price (Chapter 7 of the Roadmap)

D.5.1 Allocation of the Transaction Price for Discounts and Variable Consideration (March 2015 TRG Meeting)

Because discounts may be variable consideration, stakeholders have questioned which guidance should be applied when an entity's contract with a customer includes a discount.

TRG members generally agreed with the FASB and IASB staffs that ASC 606-10-32-41 establishes a hierarchy that requires an entity to identify, and allocate variable consideration to, performance obligations before applying other guidance (e.g., the guidance on allocating a discount). Accordingly, an entity would first determine whether a discount is variable consideration. If the entity concludes that the discount is variable consideration, it would apply the variable consideration allocation guidance if the related criteria are met. Otherwise, the entity would look to the discount allocation guidance to determine how to allocate the discount.

D.6 Step 5 — Recognize Revenue (Chapter 8 of the Roadmap)

D.6.1 Evaluating How Control Transfers Over Time (April 2016 FASB-Only TRG Meeting)

Stakeholders have articulated two views on whether an entity that is performing over time can transfer control of a good or service underlying a performance obligation at discrete points in time:

- *View A* — Satisfaction of any of the requirements for recognition over time implies that control does not transfer at discrete points in time. Therefore, an entity's use of an appropriate measure of progress should not result in its recognition of a material asset (e.g., work in progress) for performance the entity has completed. Proponents of View A point to paragraphs BC125, BC128, BC130, BC131, BC135, and BC142 of ASU 2014-09, which clarify that control of any asset (such as work in progress) transfers to the customer as progress is made.
- *View B* — Satisfaction of any of the criteria for recognition over time does not preclude transfer of control at discrete points in time. The use of an appropriate measure of progress could therefore result in the recognition of a material asset for performance under a contract. Proponents of View B emphasized that ASC 606-10-25-27(c) specifically "contemplates transfer of control at discrete points in time." They also noted that the term "could" in paragraph BC135 implies that in certain circumstances, the customer may not control the asset as performance occurs. In addition, proponents of View B indicated that "if control can never transfer at discrete points in time, certain methods of progress referenced in the new revenue standard [e.g., milestones[29]] rarely would be permissible."[30]

[29] Footnote 1 in TRG Agenda Paper 53 notes that as used in the discussion, "milestones" refer to measures of progress (i.e., they correlate to an entity's performance toward complete satisfaction of a performance obligation) rather than the "milestone method" under existing U.S. GAAP.

[30] Quoted from paragraph 19 of TRG Agenda Paper 53.

TRG members generally agreed with View A that the satisfaction of any of the requirements for revenue recognition over time implies that control does not transfer to the customer at discrete points in time. Consequently, an entity should not record material work in progress that is associated with a performance obligation that is satisfied over time.

Certain TRG members questioned the FASB staff's view that there could be times when an entity may recognize an immaterial asset (e.g., work in progress) under a recognition-over-time model because the entity's selected measure of progress may not perfectly match its performance. Specifically, they cited ASC 340-40-25-8, which requires an entity to recognize costs related to satisfied and partially satisfied performance obligations as expenses when they are incurred.

TRG members indicated that an asset could result from activities that are not specific to the customer contract (i.e., the creation of general inventory). They reiterated the importance of understanding the differences between costs associated with the development of an asset that transfers to a customer as it is created and costs to develop assets for general inventory (i.e., before the asset undergoes modifications that are specific to the customer). One TRG member discussed an example that involved large, complex, and customized assets. He noted that activities can be performed to assemble parts, for example, and that such costs may represent inventory (and thus an asset) because the assets are interchangeable for use in more than one customer contract.

However, provided that the entity has a present right to payment, revenue recognition would begin (and the inventory would be derecognized) when the asset no longer has an alternative use (i.e., when customization of the asset to the customer's specifications begins or the other criteria for revenue recognition over time are met). Once the criteria for recognition over time are met, control of the asset transfers to the customer as the asset is created.

D.6.2 Practical Expedient for Measuring Progress Toward Complete Satisfaction of a Performance Obligation (July 2015 TRG Meeting)

Stakeholders have asked whether the invoice practical expedient may be used for contracts in which the unit price or rate varies during the contract period. In analyzing the question, the FASB and IASB staffs discussed two examples: (1) a six-year contract in which an electric power company sells energy to a buyer at rates that increase every two years and (2) an IT outsourcing contract in which the prices decrease over the contract period.[31]

TRG members generally agreed with the staffs' analysis and conclusions that the invoice practical expedient could be used for both contract examples because the respective price and rate changes reflect the "value to the customer of each incremental good or service that the entity transfers to the customer."[32] For the energy contract, the changing prices "reflect the value to the customer because the rates are based on one or more market indicators"; and the changing prices in the IT outsourcing contract "reflect the value to the customer, which is corroborated through (1) the benchmarking (market) adjustment and (2) declining costs (and level of effort) of providing the tasks that correspond with the declining pricing of the activities."[33] The SEC observer also emphasized that a registrant should have sufficient evidence that demonstrates value to the customer.

[31] Considered in TRG Agenda Paper 40.

[32] Quoted from TRG Agenda Paper 40. See paragraph BC167 of ASU 2014-09 for additional information about this notion. The staffs also clarified that the phrase "value to the customer" has a context in ASC 606-10-55-17 that differs from its context in ASC 606-10-55-18.

[33] Quoted from TRG Agenda Paper 40.

In addition, the TRG discussed up-front and back-end fees, noting that while such fees do not preclude application of the invoice practical expedient, entities must use judgment in determining whether the value of the fee to the customer corresponds to the amount transferred to the customer.

The TRG also generally agreed with the staffs' view that the disclosure practical expedient may be used only if an entity applies the measurement practical expedient.

D.6.3 Measuring Progress When Multiple Goods or Services Are Included in a Single Performance Obligation (July 2015 TRG Meeting)

Stakeholders have questioned:

- Whether an entity may apply more than one method to measure the progress of a performance obligation containing multiple goods or services that are bundled and recognized over time.
- How to measure progress toward satisfaction of a performance obligation involving a bundle of goods or services. For example, if multiple promised goods or services in a performance obligation are delivered in various periods, there are questions about how an entity should select a single method by which to measure progress for the respective goods and services.

TRG members generally agreed with the FASB and IASB staffs' analysis and conclusions related to these issues, including the determination that a common (i.e., single) measure of progress is required for a single performance obligation. They observed that selecting a common measure of progress may be challenging when a single performance obligation contains more than one good or service or has multiple payment streams, and they emphasized that the selection is not a free choice. Further, they noted that while a common measure of progress that does not depict the economics of the contract may indicate that the arrangement contains more than one performance obligation, it is not determinative.

D.6.4 Partial Satisfaction of Performance Obligations Before the Contract Is Identified (March 2015 TRG Meeting)

Entities sometimes begin activities on a specific anticipated contract with their customer before (1) they agree to the contract or (2) the contract meets the criteria in step 1 of the new revenue standard. The FASB and IASB staffs refer to the date on which the contract meets the step 1 criteria as the "contract establishment date" (CED) and refer to activities performed before the CED as "pre-CED activities."[34]

The staffs noted that stakeholders have identified two issues with respect to pre-CED activities: (1) how to recognize revenue from pre-CED activities and (2) how to account for certain fulfillment costs incurred before the CED.

TRG members generally agreed with the staffs' conclusion that once the criteria in step 1 have been met, entities should recognize revenue for pre-CED activities on a cumulative catch-up basis (i.e., record revenue as of the CED for all satisfied or partially satisfied performance obligations) rather than prospectively because cumulative catch-up is more consistent with the new revenue standard's core principle.

[34] In paragraph 3 of TRG Agenda Paper 33, the staffs noted that pre-CED activities may include (1) "administrative tasks that neither result in the transfer of a good or service to the customer, nor fulfil the anticipated contract"; (2) "activities to fulfil the anticipated contract but which do not result in the transfer of a good or service, such as set-up costs"; or (3) "activities that transfer a good or service to the customer at or subsequent to the CED."

TRG members also generally agreed that certain fulfillment costs before the CED are capitalized as costs to fulfill an anticipated contract. However, these costs would be expensed immediately as of the CED if they are related to progress made to date because the goods or services constituting a performance obligation have already been transferred to the customer. The remaining asset would be amortized over the period in which the related goods or services will be transferred to the customer.

D.6.5 Determining When Control of a Commodity Is Transferred (July 2015 TRG Meeting)

Stakeholders have raised questions regarding the determination of when an entity transfers control of a commodity. Specifically, they have questioned whether revenue for delivery of a commodity should be recognized at a point in time or over time.[35] One of the criteria for recognizing revenue over time is the customer's simultaneous receipt and consumption of the benefits of the commodity as the entity performs.

TRG members agreed with the FASB and IASB staffs' conclusion that an entity must consider "all relevant facts and circumstances, including the inherent characteristics of the commodity, the contract terms, and information about infrastructure or other delivery mechanisms."[36]

D.7 Contract Modifications (Chapter 9 of the Roadmap)

D.7.1 Contract Asset Treatment in Contract Modifications (April 2016 FASB-Only TRG Meeting)

Unlike current U.S. GAAP, under which there is limited guidance on accounting for modifications of revenue contracts, the new revenue standard provides an overall framework for modification accounting.[37] For example, under the new standard, when a contract modification meets the conditions in ASC 606-10-25-13(a), the modification is accounted for prospectively as a termination of the existing contract and creation of a new one. The new revenue standard also requires entities to record contract assets[38] in certain circumstances, and these assets may still be recorded at the time of a contract modification.

Stakeholders have expressed two views on how to subsequently account for contract assets that exist before a contract is modified when a contract modification meets the conditions in ASC 606-10-25-13(a):

- *View A* — A terminated contract no longer exists. Accordingly, contract assets associated with the terminated contract should be written off to revenue (i.e., revenue should be reversed).
- *View B* — Existing contract assets should be carried forward to the new contract and realized as receivables[39] are recognized (i.e., revenue is not reversed, leading to prospective accounting for the effects of the contract assets).

The TRG generally agreed with View B for three reasons. First, it better reflects the objective of ASC 606-10-25-13. Second, ASC 606-10-25-13(a) "explicitly states that the starting point for the determination [of the allocation in a modification] is the transaction price in the original contract *less* what had already been recognized as revenue."[40] Third, it is consistent with paragraph BC78 of ASU 2014-09, which notes

[35] See ASC 606-10-25-27(a).
[36] Quoted from TRG Agenda Paper 43.
[37] ASC 606-10-25-10 through 25-13.
[38] ASC 606-10-45-1 through 45-5.
[39] See ASC 606-10-45-4 for additional information.
[40] Quoted from paragraph 14 of TRG Agenda Paper 51.

that the intent of ASC 606-10-25-13(a) is to avoid adjusting revenue for performance obligations that have been satisfied (i.e., such modifications would be accounted for prospectively).

D.8 Principal-Versus-Agent Considerations (Chapter 10 of the Roadmap)

D.8.1 Assessing Whether an Entity Is a Principal or an Agent (July 2014 TRG Meeting)

Arrangements involving "virtual" goods and services — intangible goods and services that continue to be offered on the Internet through social networking Web sites and mobile application stores — may complicate the assessment of whether an entity is a principal or an agent. Because of the nature of such arrangements (and others, such as arrangements involving rights conveyed through gift cards), the TRG discussed the following implementation issues:

- How control would be assessed with respect to the originator and intermediary, including the impact on the principal-agent assessment when an originator has no knowledge of the amount an intermediary charged a customer for virtual goods or services.
- The order of steps for determining whether an entity is a principal or an agent. For example, it is unclear whether (1) the agency indicators in the new revenue standard are intended to help an entity initially assess who controls the goods or services or (2) the entity would apply the agency indicators only after it cannot readily determine who controls the goods or services.
- How to apply the agency indicators to the originator and intermediary (e.g., if certain indicators apply to both the originator and the intermediary).
- Whether certain indicators either are more important or should be discounted (e.g., whether inventory risk would be applicable in arrangements involving virtual goods or services).

In addition, the new revenue standard requires an entity to allocate the total consideration in a contract with a customer to each of the entity's performance obligations under the contract, including discounts. Stakeholders have questioned whether discounts should be allocated to all performance obligations and whether consideration should be allocated on a gross or net basis if the entity is a principal for certain performance obligations but an agent for others.

TRG members did not reach general agreement on the issues discussed and believed that clarifications to principal-versus-agent guidance in the new revenue standard would be helpful.

On March 17, 2016, the FASB issued ASU 2016-08 to address issues raised regarding how an entity should assess whether it is the principal or the agent in contracts that include three or more parties.

Specifically, the guidance requires an entity to determine:

- The nature of its promise to the customer. If the entity's obligation is to provide the customer with a specified good or service, it is the principal. Otherwise, if the entity's obligation is to arrange for the specified good or service to be provided to the customer by a third party, the entity is an agent.
- Who controls the specified good or service before it is transferred to the customer. An entity is a principal "if it controls the specified good or service before that good or service is transferred to a customer."

Further, the ASU clarifies that the unit of account is a specified good or service (which is a distinct good or service or a bundle of distinct goods or services) and that an entity may be the principal with respect to certain specified goods or services in a contract but may be an agent with respect to others.

The ASU also adds clarifying guidance on the types of goods or services that a principal may control[41] and reframes the principal-versus-agent indicators in the new revenue standard to (1) illustrate when an entity may be acting as a principal instead of when an entity acts as an agent and (2) explain how each indicator is related to the control principle. For additional information, see Chapter 10.

D.9 Licensing (Chapter 11 of the Roadmap)

D.9.1 Licenses of IP (October 2014 TRG Meeting)

Because of the impact of a licensor's ongoing activities on the determination of whether a license of IP is a right-to-use or right-to-access license, the TRG discussed how entities should evaluate such ongoing activities. Issues noted by stakeholders include whether:

- An entity is required to identify the nature of a license when the license is not distinct (i.e., determine whether the license is satisfied over time or at a point in time when it is not a separate performance obligation).
- A license may be classified as a right to access:
  - Only if the licensor's contractual or expected activities change the form or functionality of the underlying IP.
  - If there are significant changes in the value of the IP (because such changes alone would constitute a change to the IP).
- In the case of a license that does not require the customer to use the most recent version of the underlying IP, the licensor's activities directly expose the customer to positive or negative effects of the IP.
- Activities transferring a good or service that is not separable from a license of IP should be considered to determine the nature of the license.
- Restrictions in a contract for a license of IP affect the determination of the number of performance obligations in the contract (i.e., the number of distinct licenses).

TRG members did not reach general agreement on these topics and believed that clarifications to the guidance would be helpful.

On April 14, 2016, as noted in Section D.3.1 above, the FASB issued ASU 2016-10, which amends certain aspects of the new revenue standard, specifically the guidance on identifying performance obligations and the implementation guidance on licensing. The ASU revises the guidance in ASC 606 to distinguish between two types of licenses: (1) functional IP and (2) symbolic IP, which are classified according to whether the underlying IP has significant stand-alone functionality (e.g., the ability to process a transaction, perform a function or task, or be played or aired). For additional information, see Chapter 11.

D.9.2 Licenses — Restrictions and Renewals (November 2015 TRG Meeting)

The TRG discussed the following issues related to point-in-time licenses:

- *Renewals of time-based right-to-use (point-in-time) licenses* — Whether a term extension represents a change in an attribute of a license that has already been transferred to a customer.
- *Distinct rights in a current contract versus those added through a contract modification* — Whether the removal of restrictions on the use of the underlying IP in a multiyear license (e.g.,

[41] See ASC 606-10-55-37A (added by the ASU).

geographical and product-class restrictions) conveys additional rights to the customer and thus represents distinct licenses. In addition, there are questions regarding how an entity would account for such releases affected through a contract modification (i.e., whether an entity would follow the new revenue standard's modification guidance).

- *Accounting for a customer's option to purchase or use additional copies of software* — Whether options to acquire additional software rights should be accounted for (1) in accordance with the royalty constraint guidance because they are related to licenses of IP or (2) in a manner similar to the accounting for options to purchase additional goods because control is transferred at a point in time.

TRG members generally agreed that:

- The evaluation of whether an entity has provided a single license of IP or multiple licenses to a customer (either in a single contract or through contract modifications) would depend on whether it has granted the customer additional rights (i.e., new or expanded rights).
- The modification of a license arrangement should be treated no differently from the modification of a contract for goods or services. Therefore, an entity should apply the contract modification guidance in the new revenue standard.

However, the TRG did not reach general agreement about:

- Why a time-based restriction would be treated differently from a geographical or product-based restriction. That is, many TRG members viewed the extension of time (i.e., through the contract renewal) as granting a customer an additional right rather than the continued use of the same rights under a license that the entity already delivered to the customer and from which the customer is currently benefiting).
- Whether additional copies of software would be accounted for as a customer option or as a usage-based royalty.

ASU 2016-10 includes additional illustrative examples to clarify that restrictions of time, geographical region, or use affect the scope of the customer's right to use or right to access the entity's IP (i.e., they are attributes of a license) and do not define the nature of the license (i.e., functional versus symbolic). However, restrictions should be distinguished from contractual provisions that, explicitly or implicitly, require the entity to transfer additional goods or services (including additional licenses) to the customer.

In addition, ASU 2016-10 clarifies that revenue should not be recognized for renewals or extensions of licenses to use IP until the renewal period begins.

For additional information on restrictions and renewals, see Chapter 11.

D.9.3 Sales- and Usage-Based Royalties (July 2014 TRG Meeting)

The TRG discussed issues regarding how the royalty constraint would apply when a license of IP is offered with other goods or services in a contract (e.g., software licenses with PCS, franchise licenses with training services, biotechnology and pharmaceutical licenses sold with research and development services or a promise to manufacture a drug for the customer).

Views differ on whether the royalty constraint should apply to circumstances in which a royalty is (1) related to both a distinct license and nonlicense goods or services that are distinct from the license and (2) combined with other nonlicense goods or services in the contract (i.e., it is not distinct).

TRG members did not reach general agreement and noted their belief that stakeholders would benefit from additional clarifications to the new revenue standard.

ASU 2016-10 clarifies that the sales- or usage-based royalty exception applies whenever the royalty is predominantly related to a license of IP. The ASU therefore indicates that an "entity should not split a sales-based or usage-based royalty into a portion subject to the recognition guidance on sales-based and usage-based royalties and a portion that is not subject to that guidance."

D.10 Contract Costs (Chapter 12 of the Roadmap)

D.10.1 Costs of Obtaining a Contract (January 2015 TRG Meeting)

Because many entities pay sales commissions to obtain contracts with customers, questions have arisen regarding how to apply the new revenue standard's cost guidance to such commissions, including:

- Whether certain commissions (e.g., commissions on contract renewals or modifications, commission payments that are contingent on future events, and commission payments that are subject to "clawback" or thresholds) qualify as contract assets.
- The types of costs to capitalize (e.g., whether and, if so, how an entity should consider fringe benefits such as payroll taxes, pension, or 401(k) match) in determining the amount of commissions to record as incremental costs.
- The pattern of amortization for assets related to multiple performance obligations (e.g., for contract cost assets related to multiple performance obligations that are satisfied over disparate points or periods of time).

TRG members generally agreed that entities would continue to first refer to existing GAAP on liability recognition to determine whether and, if so, when a liability from a contract with a customer needs to be recorded. For example, an entity would apply the specific GAAP on liability recognition (e.g., commissions, payroll taxes, 401(k) match) and then determine whether to record the related debit as an asset or expense.

TRG members also noted that there is no need for prescriptive guidance on amortization periods and methods and that the new revenue standard is clear that (1) an entity's method should be on a systematic basis and (2) the period should reflect the pattern of transfer of goods or services to a customer.

D.10.2 Impairment Testing of Capitalized Contract Costs (July 2014 TRG Meeting)

To test contract assets for impairment, an entity must consider the total period over which it expects to receive an economic benefit from the contract asset. Accordingly, to estimate the amount of remaining consideration that it expects to receive, the entity would also need to consider goods or services under a specific anticipated contract (i.e., including renewals). However, the impairment guidance appears to contradict itself because it also indicates that entities should apply the principles used to determine the transaction price when calculating the "amount of consideration that an entity expects to receive."[42] The determination of the transaction price would exclude renewals.[43]

TRG members generally agreed that when testing a contract asset for impairment, an entity would consider the economic benefits from anticipated contract extensions or renewals if the asset is related to the goods and services that would be transferred during those extension or renewal periods.

On May 18, 2016, as noted in Section D.1.2 above, the FASB issued a proposed ASU on technical corrections to the new revenue standard. The proposed ASU would amend ASC 340-40 to clarify that for impairment testing, an entity should:

- Consider contract renewals and extensions when measuring the remaining amount of consideration the entity expects to receive.
- Include in the amount of consideration the entity expects to receive both (1) the amount of cash expected to be received and (2) the amount of cash already received but not yet recognized as revenue.
- Test for and recognize impairment in the following order: (1) assets outside the scope of ASC 340-40 (such as inventory under ASC 330), (2) assets accounted for under ASC 340-40, and (3) reporting units and asset groups under ASC 350 and ASC 360.

Refer to Chapter 19.

D.10.3 Preproduction Activities (November 2015 TRG Meeting)

The new revenue standard creates new guidance on fulfillment costs that are outside the scope of other Codification topics, including costs related to an entity's preproduction activities. The Basis for Conclusions of ASU 2014-09 indicates that in developing such cost guidance, the FASB and IASB did not intend to holistically reconsider cost accounting. Rather, they aimed to:

- Fill gaps resulting from the absence of superseded guidance on revenue (and certain contract costs).
- Improve consistency in the application of certain cost guidance.
- Promote convergence between U.S. GAAP and IFRSs.

Summarized below is the TRG's discussion of three issues related to how an entity should apply the new cost guidance when assessing preproduction activities, including questions related to the scope of the guidance (i.e., the costs to which such guidance would apply).

[42] ASC 340-40-35-4.

[43] ASC 606-10-32-4 states, "For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified."

D.10.3.1 Assessing Whether Preproduction Activities Are a Promised Good or Service

The TRG generally agreed that an entity should first evaluate the nature of its promise to the customer and, in doing so, consider whether a preproduction activity is a promised good or service (i.e., the preproduction activity transfers control of a good or service to the customer) or a fulfillment activity. Further, the criteria for determining whether an entity transfers control of a good or service over time[44] may be helpful in this assessment. For example, if an entity determines that a preproduction activity transfers control of a good or service to a customer over time, it should include the preproduction activity in its measure of progress toward complete satisfaction of its performance obligation(s).

D.10.3.2 Whether Entities Should Continue to Account for Certain Preproduction Costs Under ASC 340-10

TRG members in the United States agreed that since the new revenue standard does not amend the guidance in ASC 340-10, entities that currently account for preproduction costs in accordance with ASC 340-10 should continue to do so after the new revenue standard becomes effective. See Chapter 19 for further developments on this matter.

D.10.3.3 Whether Preproduction Costs for Contracts Previously Within the Scope of ASC 605-35 Will Be Within the Scope of ASC 340-10 or ASC 340-40

TRG members in the United States noted that after the new revenue standard becomes effective, preproduction activities related to contracts currently within the scope of ASC 605-35 should be accounted for in accordance with ASC 340-40 because (1) the new revenue standard will supersede ASC 605-35 (and its related cost guidance) and (2) ASC 340-10 does not currently provide guidance on costs related to such contracts. Further, TRG members in the United States noted that implementation questions related to whether and, if so, how to apply ASC 340-10 may be resolved if that guidance is either (1) deleted or (2) clarified to enable entities to understand how to apply it in a manner consistent with the control principle in the new revenue standard.

On May 18, 2016, as noted in Section D.1.2 above, the FASB issued a proposed ASU on technical corrections to the new revenue standard. The proposed ASU would remove the guidance in ASC 340-10 on accounting for preproduction costs related to long-term supply arrangements. Instead of accounting for such costs in accordance with ASC 340-10, entities would account for them in accordance with ASC 340-40. See Chapter 19 for further developments on this matter.

D.11 Presentation (Chapter 13 of the Roadmap)

D.11.1 Presentation of Contract Assets and Contract Liabilities (October 2014 TRG Meeting)

Although certain types of assets and liabilities result from revenue arrangements under existing GAAP, issues have been identified regarding how contract assets and contract liabilities should be presented under the new revenue standard. These issues include:

- *Determining the unit of account* — The TRG generally agreed that the contract, and not individual performance obligations, is the appropriate unit of account for presenting contract assets and contract liabilities.

[44] Discussed in ASC 606-10-25-27.

- *Presenting contract assets and contract liabilities for individual contracts* — TRG members generally agreed that contract assets or contract liabilities should be presented for each contract on a net basis.
- *Presenting contract assets and contract liabilities for combined contracts* — The TRG generally agreed that when contracts meet the criteria for combination under the new revenue standard, a contract asset or contract liability should be presented for the combined contract.
- *Offsetting other assets and contract liabilities against contract assets and contract liabilities* — TRG members generally agreed that entities should look to existing guidance to determine whether they have the right of offset.[45] It was also noted that netting of contract assets and contract liabilities reflects an entity's net position for the remaining rights and obligations under the contract and therefore is different from offsetting.

D.12 Effective Date and Transition (Chapter 15 of the Roadmap)

D.12.1 Contract Modifications at Transition (January 2015 TRG Meeting)

To adopt ASC 606, entities will need to account for the effects of contract modifications for the periods called for by the transition method elected. For some entities, however, accounting for contract modifications before the date of initial adoption will be challenging — if not impracticable[46] — because of the high volume and long duration of customer contracts that are frequently modified. Accordingly, stakeholders expressed the view that a practical expedient should be added to the new revenue standard.

TRG members generally agreed that a practical expedient would be helpful, and the FASB staff noted at the January 2015 TRG meeting that the FASB was considering such a practical expedient.

On May 9, 2016, as noted in Section D.2.2 above, the FASB issued ASU 2016-12, which amends certain aspects of the new revenue standard. The ASU provides a practical expedient for situations in which an entity uses the retrospective transition method to evaluate contract modifications that occurred before the beginning of the earliest period presented. The practical expedient does not require entities to evaluate the impact of each contract modification before the beginning of the earliest period presented. Entities are also permitted to apply the practical expedient if they elect the modified retrospective transition approach for contract modifications to either (1) all contracts as of the initial application date or (2) all contracts that have not been completed as of the initial application date. Whichever transition method is used, an entity that elects to apply the practical expedient must apply it consistently to all contracts and disclose the method it applies. For additional information, see Chapter 15.

D.12.2 Completed Contracts at Transition (July 2015 TRG Meeting)

Under the modified retrospective transition method, entities have the option to apply the new revenue standard only to contracts that are not completed as of the date of initial application. The new revenue standard states that a contract is considered completed if the entity has transferred all of the goods or services identified in accordance with current GAAP. In light of this, stakeholders questioned (1) when a contract is considered completed for purposes of applying the transition guidance under the modified retrospective method and (2) how to account for completed contracts after adoption of the new revenue standard.[47]

[45] ASC 210-20, IAS 1, and IAS 32.
[46] As used in ASC 250 and IAS 8.
[47] It was noted that these issues pertain primarily to U.S. GAAP but that similar issues could arise under IFRSs.

TRG members generally agreed that a practical expedient or further clarifications to the guidance would be helpful.

ASU 2016-12 clarifies that a completed contract is one in which all (or substantially all) of the revenue has been recognized under the applicable revenue guidance before the new revenue standard is initially applied. For additional information, see Chapter 15.

Appendix E — Chronological Listing of Revenue Implementation Issues Discussed by the TRG to Date

E.1 July 2014 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the July 2014 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Gross versus net revenue presentation — assessing whether an entity is a principal or an agent	D.8.1	• Application of the agency indicators in ASC 606-10-55-59: ◦ Interaction of the agency indicators with the principle that a principal controls the good or service before its transfer to the customer. ◦ Application of the agency indicators to some types of contracts (specifically, contracts for intangible goods or services and contracts for which the indicators provide contradictory evidence). • If an entity makes a determination that it is a principal (which typically results in the recognition of gross revenue), what amount of revenue should the entity recognize if it received a net amount of cash and does not know the gross amount? • How should the transaction price allocation guidance be applied to a transaction in which the entity is a principal for some of the deliverables and an agent for others?	TRG Agenda Paper 1
Gross versus net revenue — amounts billed to customers	D.4.1	How should entities determine the presentation of amounts billed to customers under the new revenue standard?	TRG Agenda Paper 2
Sales- and usage-based royalties	D.9.3	• When is a sales- or usage-based royalty "promised in exchange for a license of intellectual property" such that the royalty constraint should apply? • Can a royalty be partially within the scope of the royalty constraint?	TRG Agenda Paper 3

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Impairment testing of capitalized contract costs	D.10.2	How should an entity consider renewals and extensions when performing an impairment test on capitalized contract costs?	TRG Agenda Paper 4

For additional information about the July 2014 TRG meeting, see TRG Agenda Paper 5 and Deloitte's July 2014 *TRG Snapshot*.

E.2 October 2014 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the October 2014 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Customer options	D.3.7	• Should the evaluation of whether an option provides a material right be performed in the context of only the current transaction with a customer, or should the evaluation also consider past and expected future transactions with the customer? • Is the evaluation of whether an option provides a material right solely a quantitative evaluation, or should the evaluation also consider qualitative factors?	TRG Agenda Paper 6
Presentation of contract assets and contract liabilities	D.11.1	• How should an entity determine the presentation of a contract that contains multiple performance obligations? • How should an entity determine the presentation of two or more contracts that have been combined under step 1 (identify the contract with the customer) in accordance with ASC 606-10-25-9? • When can an entity offset other balance sheet items against the contract asset or contract liability?	TRG Agenda Paper 7

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Licenses of intellectual property (IP)	D.9.1	• For a license of IP that is not a separate performance obligation, does an entity need to determine the nature of the license as a right to access the entity's IP or a right to use the entity's IP (i.e., determine whether the license is satisfied over time or at a point in time)? • For the nature of a license to be a right to access the entity's IP as it exists throughout the license period, (1) do the contractual or expected activities of the licensor have to change the form or functionality of the underlying IP, or (2) do significant changes in the value of the IP alone constitute a change to the IP? ◦ If a customer is not required to use the most recent version of the underlying IP, do the licensor's activities directly expose the customer to positive or negative effects of the IP to which the customer has rights? ◦ Should the entity consider activities that transfer a good or service that is not separable from the license of IP in determining the nature of the license under ASC 606-10-55-60(c)? • Can restrictions in a contract for a license of IP affect the determination of whether that contract contains one or multiple licenses when the entity applies step 2 (identify performance obligations) of the new revenue standard?	TRG Agenda Paper 8
Distinct in the context of the contract	D.3.3	How should entities assess whether a good or service is distinct in the context of the contract?	TRG Agenda Paper 9
Contract enforceability and termination clauses	D.2.1	How should an entity evaluate termination clauses in determining the duration of a contract (i.e., the contractual period)?	TRG Agenda Paper 10

For additional information about the October 2014 TRG meeting, see TRG Agenda Paper 11 and Deloitte's October 2014 *TRG Snapshot*.

E.3 January 2015 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the January 2015 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Identifying promised goods or services	D.3.1	What are the promised goods or services in a contract with a customer?	TRG Agenda Paper 12

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Collectibility	D.2.2	• How should an entity assess collectibility for a portfolio of contracts? • When should an entity reassess collectibility? • How should an entity recognize revenue on contracts that are subsequently reassessed as not probable of collection (i.e., after being assessed as collectible at contract inception)? • How should an entity assess whether a contract includes a price concession?	TRG Agenda Paper 13
Variable consideration	D.4.2	• When should an entity recognize consideration payable to a customer? • Should the constraint on variable consideration be applied at the contract level or the performance obligation level?	TRG Agenda Paper 14
Noncash consideration	D.4.5	• What is the measurement date for noncash consideration received (or receivable) from a customer? • How is the constraint applied to transactions in which the fair value of noncash consideration might vary because of the form of the consideration and for reasons other than the form of the consideration?	TRG Agenda Paper 15
Stand-ready obligations	D.3.2	• What is the nature of the promise to the customer in arrangements? • How should an entity measure progress toward the complete satisfaction of a stand-ready obligation (i.e., 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?	TRG Agenda Paper 16
Islamic finance transactions	N/A	Whether deferred-payment transactions (with the possible exception of the "first type" described in paragraph 7 of TRG Agenda Paper 17) must first pass through IFRS 15 before being reported under IFRS 9 since the Islamic financial institution must possess the underlying assets, even for a very short period, with all risks and rewards incidental to ownership before the subsequent sale.	TRG Agenda Paper 17
Material rights	D.3.7	• Accounting for a customer's exercise of a material right. • Material rights and significant financing components. • Determining when a material right exists.	TRG Agenda Paper 18

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Consideration payable to a customer	D.4.3	• Are entities required to apply the guidance on consideration payable to a customer at the contract level or more broadly to the entire "customer relationship"? • Does the guidance on payments made to a customer or "to other parties that purchase the entity's goods or service from the customer" apply only to customers in the distribution chain, or does it apply more broadly to any customer of an entity's customer? • Timing of recognizing consideration payable to a customer that is anticipated, but not yet promised, to the customer. • "Negative revenue" resulting from consideration payable to a customer.	TRG Agenda Paper 19
Significant financing components	D.4.6	• Should the factor in ASC 606-10-32-17(c) be applied broadly (in a manner consistent with Example 30 of ASC 606)? • If the implied interest rate in an arrangement is zero (i.e., interest-free financing) such that the consideration to be received is equal to the cash selling price, does a financing component exist? • How should an entity adjust for the time value of money when the consideration is received up front and revenue is recognized over multiple years?	TRG Agenda Paper 20

Costs of obtaining a contract	D.10.1	• Commission paid on renewals after the initial contract is obtained:
		  ◦ Capitalization of the commission.
		  ◦ What is the amortization period?
		  ◦ How should entities evaluate whether a commission paid for a renewal is "commensurate with" a commission paid on the initial contract (when determining the appropriate amortization period for an initial commission)?
		• Should commissions earned on contract modifications (that are not treated as separate contracts) be capitalized?
		• Are costs incremental if they are contingent on future events?
		• Should commission payments subject to "clawback" (i.e., repayment to the entity if the customer does not perform) be capitalized as an incremental cost of obtaining a contract?
		• Should commissions based on achieving cumulative targets be capitalized?
		• Should entities consider fringe benefits (e.g., payroll taxes, pension/401(k) match, FICA) in the assessment of determining the amount of commissions to record as incremental costs?
		• How should entities determine the pattern of amortization for a contract cost asset related to multiple performance obligations that are satisfied over disparate points or periods of time?
			TRG Agenda Paper 23

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Contract modifications — practical expedient at transition	D.12.1	Should a practical expedient (and a requirement to disclose the use of that practical expedient) be provided to address some of the potential challenges (and costs) that an entity might face when applying the guidance on contract modifications before the date of initial adoption?	TRG Agenda Paper 24

For additional information about the January 2015 TRG meeting, see TRG Agenda Paper 25 and Deloitte's January 2015 *TRG Snapshot*.

E.4 March 2015 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the March 2015 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Contributions	D.1.3	Are contributions within the scope of the new revenue standard?	TRG Agenda Paper 26
Series of distinct goods or services	D.3.4	• Does the series provision apply only if the goods are delivered, or the services are performed, consecutively? • For the series provision to apply, does the accounting result need to be the same as if the underlying distinct goods and services each were accounted for as a separate performance obligation?	TRG Agenda Paper 27
Consideration payable to a customer	D.4.3	• Which payments to a customer are within the scope of the guidance on consideration payable to a customer? • Is the guidance on consideration payable to a customer related to customers in the distribution chain or more broadly to any customer of an entity's customer? • Timing of recognition of consideration payable to a customer.	TRG Agenda Paper 28
Warranties	D.3.8	How should an entity evaluate whether a product warranty is a performance obligation in a contract with a customer when the warranty is not separately priced?	TRG Agenda Paper 29

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Significant financing components	D.4.6	• How should an entity apply the factor in ASC 606-10-32-17(c) in determining when the difference between promised consideration and cash selling price is not related to a significant financing component? • If the promised consideration is equal to the cash selling price, does a financing component exist? • Does the new revenue standard preclude accounting for financing components that are not significant? • How should entities determine whether the practical expedient can be applied in scenarios in which there is a single payment stream for multiple performance obligations? • How should an entity calculate the adjustment of revenue in arrangements that contain a significant financing component? • How should the significant financing guidance be applied when there are multiple performance obligations?	TRG Agenda Paper 30
Variable discounts	D.5.1	What is the interaction between the guidance on allocating discounts and the guidance on allocating variable consideration?	TRG Agenda Paper 31
Exercise of material rights	D.3.7	• How should an entity account for a customer's exercise of a material right? • How should an entity evaluate whether a customer option that provides a material right includes a significant financing component? • Over what period should an entity recognize a nonrefundable up-front fee?	TRG Agenda Paper 32
Partially satisfied performance obligations	D.6.4	• How should revenue arising from pre-CED activities be recognized? • How should an entity account for fulfillment costs incurred before the CED?	TRG Agenda Paper 33

For additional information about the March 2015 TRG meeting, see TRG Agenda Paper 34 and Deloitte's March 2015 *TRG Snapshot*.

E.5 July 2015 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the July 2015 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Accounting for restocking fees and related costs	D.4.7	• How should an entity account for restocking fees for widgets expected to be returned? • How should an entity account for restocking costs for expected widget returns (e.g., estimated shipping or repackaging costs)?	TRG Agenda Paper 35
Scope: credit cards	D.1.1	• Are the rights and obligations of a card-issuing bank's contract with a cardholder within the scope of ASC 606? • Are cardholder reward programs subject to the guidance in ASC 606?	TRG Agenda Paper 36
Consideration payable to a customer	D.4.3	• Which payments to a customer are within the scope of the guidance on consideration payable to a customer? • Who are considered an entity's customers under the guidance on consideration payable to a customer? • How does the guidance on timing of recognition of consideration payable to a customer reconcile with the variable consideration guidance?	TRG Agenda Paper 37
Portfolio practical expedient and application of the variable consideration constraint	D.4.4	• Is an entity applying the portfolio practical expedient when it considers evidence from similar contracts to develop an estimate by using the expected-value method? • Can the estimated transaction price under the expected-value method be an amount that is not a possible outcome of an individual contract?	TRG Agenda Paper 38
Application of the series provision and allocation of variable consideration	D.3.5	• In the determination of whether the series provision is applicable, how should entities consider whether the performance obligation consists of distinct goods or services that are substantially the same? • If there is an undefined quantity of outputs but the contractual rate per unit of output is fixed, is the consideration variable? • For the requirement in ASC 606-10-32-40(b) to be met, is it necessary to allocate the variable consideration on a relative stand-alone selling price basis?	TRG Agenda Paper 39

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Practical expedient for measuring progress toward complete satisfaction of a performance obligation	D.6.2	• Is the practical expedient for measuring progress toward complete satisfaction of a performance obligation applicable to contracts with rates that change during the contract term? • How should entities assess whether the disclosure practical expedient in ASC 606-10-50-14 may be applied when the practical expedient for measuring progress toward complete satisfaction of a performance obligation is not used?	TRG Agenda Paper 40
Measuring progress when multiple goods or services are included in a single performance obligation	D.6.3	• Can multiple measures of progress be used to depict an entity's performance in completing a combined performance obligation? • How should an entity determine the measure of progress when a combined performance obligation satisfied over time contains multiple goods or services?	TRG Agenda Paper 41
Completed contracts at transition	D.12.2	• When is a contract considered "completed" for purposes of applying the transition guidance? • How should an entity account for "completed contracts" after adoption of the new revenue standard?	TRG Agenda Paper 42
Determining when control of a commodity is transferred	D.6.5	What factors should an entity consider when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity as the entity performs?	TRG Agenda Paper 43

For additional information about the July 2015 TRG meeting, see TRG Agenda Paper 44 and Deloitte's July 2015 *TRG Snapshot*.

E.6 November 2015 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the November 2015 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Licenses — specific application issues related to restrictions and renewals	D.9.2	• Renewals of time-based right-to-use (point in time) licenses. • Distinct rights in a contract. • Distinct rights added through a modification. • Accounting for a customer's option to purchase or use additional copies of software.	TRG Agenda Paper 45

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Preproduction activities	D.10.3	• How should an entity assess whether preproduction activities are a promised good or service (or included in the measure of progress toward complete satisfaction of a performance obligation that is satisfied over time)? • How should an entity account for preproduction costs that currently are accounted for in accordance with the guidance in ASC 340-10? (U.S. GAAP question only.) • Are preproduction costs for contracts previously within the scope of ASC 605-35 within the scope of the cost guidance in ASC 340-10 or ASC 340-40? (U.S. GAAP question only.)	TRG Agenda Paper 46
Whether fixed-odds wagering contracts are within or outside the scope of ASC 606	D.1.2	Are fixed-odds wagering contracts within the scope of ASC 606?	TRG Agenda Paper 47
Customer options for additional goods and services	D.3.6	• Optional purchases versus variable consideration. • What are optional purchases? • Why are optional purchases different from variable consideration? • Customer termination rights and penalties. • When should an optional purchase be considered a separate performance obligation?	TRG Agenda Paper 48

For additional information about the November 2015 TRG meeting, see TRG Agenda Paper 49 and Deloitte's November 2015 *TRG Snapshot*.

E.7 April 2016 TRG Meeting

The following table summarizes the revenue implementation issues discussed at the April 2016 TRG meeting:

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Scope considerations for incentive-based capital allocations, such as carried interests	D.1.4	Are incentive-based capital allocation fees (e.g., carried interests) within the scope of the new revenue standard?	TRG Agenda Paper 50

(Table continued)

Topic	Appendix D Reference	Revenue Implementation Issues or Questions Discussed	Source
Contract asset treatment in contract modifications	D.7.1	How should the existing contract asset be accounted for in a contract modification accounted for as a new contract in accordance with ASC 606-10-25-13(a)?	TRG Agenda Paper 51
Scope considerations for financial institutions	D.1.5	• Are mortgage servicing rights within the scope of the new revenue standard or ASC 860? • Are deposit-related fees within the scope of the new revenue standard or ASC 405? • Are fees from financial guarantees within the scope of the new revenue standard, or are they within the scope of ASC 460 or ASC 815?	TRG Agenda Paper 52
Evaluating how control transfers over time	D.6.1	If any of the criteria for recognizing revenue over time are met, can control of the underlying good or service transfer at discrete points in time?	TRG Agenda Paper 53
Considering the class of customer in the evaluation of whether a customer option gives rise to a material right	D.3.7.6	• How or when should an entity consider past transactions in determining the class of customer? • How should the class of customer be evaluated in the determination of the stand-alone selling price of an optional good or service?	TRG Agenda Paper 54

For additional information about the April 2016 TRG meeting, see Deloitte's April 2016 *TRG Snapshot*.

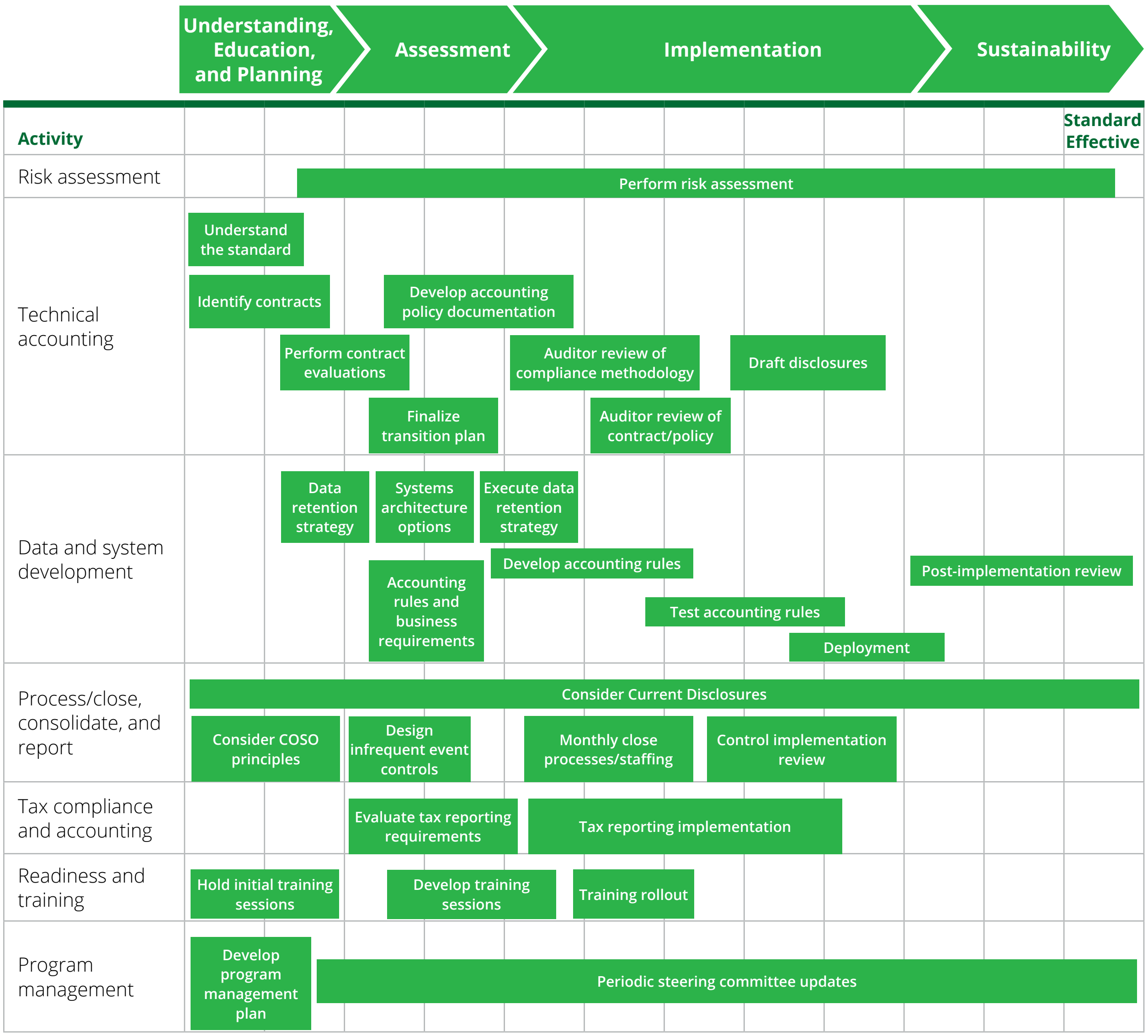
Appendix F — Roadmap for Implementation

This appendix provides an illustrative roadmap of key activities that an entity may consider including in its own roadmap for implementing the new revenue standard. The illustrative roadmap below represents the average timeline for adoption, demonstrating the relative length of time for each activity. However, each entity's timeline will vary depending on the industry or industries in which the entity operates, the variability of the contract types, existing systems and processes, and the amount of resources dedicated to the transition plan.

As illustrated in the roadmap below, the implementation of the new revenue standard is an iterative process that will require involvement of stakeholders throughout the organization. Further, while the initial steps of an implementation plan logically focus on the technical accounting issues, other aspects of the project can occur contemporaneously. As certain technical conclusions are reached, tax and IT/systems implications can be assessed, internal training can begin, and pro forma impacts can be modeled.

The four phases of adopting the new revenue standard are (1) understanding, education, and planning; (2) assessment; (3) implementation; and (4) sustainability. While the illustrative roadmap below has been broken down into these four phases, the adoption should not be viewed as a linear process since entities may have to revisit initial phases throughout the implementation process.

Illustrative Roadmap



Understanding, Education, and Planning

Understanding, Education, and Planning › Assessment › Implementation › Sustainability

Activities	Key Actions
Technical Accounting	
Understand the standard	Read and understand the standard.
Identify contracts and related accounting documentation	• Compile a complete inventory of contracts to identify standard, unique, and complex contracts for review. • Review existing whitepapers, accounting policies, narratives, and process flows to understand current revenue streams and revenue accounting policies. • Document key terms and conditions and identify data within the contracts that may be relevant to accounting for the contracts under the new revenue standard (e.g., performance obligations, transaction pricing, contingencies) and begin to evaluate implications under the new revenue standard.
Process/Close, Consolidate, and Report	
Consider current disclosures	• Determine necessary disclosures under SAB Topic 11.M.[1] • Identify current revenue recognition disclosures (e.g., Forms 10-K and 10-Q) to prepare for assessing how the disclosures will be enhanced or revised as a result of the new disclosure requirements.
Consider COSO principles	The following principles are particularly relevant at this phase of adoption [in the context of the new revenue standard]: • *COSO Principle 1* — Has an appropriate tone at the top regarding the importance of the adoption of the new revenue standard been demonstrated? • *COSO Principle 2* — Does the board of directors exercise oversight of the development of internal control related to the adoption of the new revenue standard? • *COSO Principle 4* — Has the entity identified competent individuals to implement the new revenue standard? • *COSO Principle 5* — Are individuals held accountable for their roles related to the adoption of the new revenue standard?

[1] At the 2015 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff reminded conference participants that it expects the level of disclosures to increase as the effective date of the new revenue standard approaches. For more information about the 2015 AICPA Conference, see Deloitte's December 15, 2015, *Heads Up*.

(Table continued)

Activities	Key Actions
Readiness and Training	
Hold initial training sessions	• Hold initial training session with key stakeholders and team leads. • Provide an overview of the new revenue standard, and outline key impacts on business and functional groups.
Program Management	
Develop program management plan	• Develop resource estimates for project plan; obtain stakeholder endorsement. • Establish a steering committee and appropriate governance. • Identify key project personnel to own adoption process and coordination among departments (e.g., Accounting, Finance, Financial Reporting, IT, Tax, Human Resources, Sales, Investor Relations, Legal, Internal Audit). • Develop program management reporting to permit project visibility and periodic risk management. • Review the entity's project plan with the external auditor to establish expectations and timing regarding the entity's adoption plan. • Follow the issues being deliberated by the FASB, TRG, SEC, PCAOB, AICPA, EITF, and relevant industry task forces. • Participate in industry roundtables to understand how industry-specific issues are being addressed.

Assessment

Activities	Key Actions
Risk Assessment	
Perform risk assessment	Perform risk assessment related to the adoption of the new revenue standard throughout the adoption activities.

(Table continued)

Activities	Key Actions
Technical Accounting	

Perform contract evaluations	• Perform contract evaluations for each contract type identified during the understanding, education, and planning phase:
	  ◦ Account for contracts identified under the new revenue standard:
	    ▪ Identify the contract (i.e., determine whether the contracts identified represent contracts as defined by ASC 606).
	    ▪ Identify performance obligations.
	    ▪ Determine the transaction price.
	    ▪ Allocate the transaction price.
	    ▪ Determine the amount of revenue to recognize in each relevant period to be presented in the financial statements.
	    ▪ Determine the accounting for any contract or incremental costs incurred in obtaining or fulfilling a contract.
	  ◦ Develop accounting calculation logic, journal entries, and analytical reports for contract types.
	  ◦ Draft disclosure information for reporting that contemplates requirements related to the new revenue standard and SEC reporting, as applicable.
	  ◦ Document considerations in determining the appropriate accounting for each contract type and how conclusions were reached.
	  ◦ Update process flow diagrams for each contract type as necessary.
	  ◦ Evaluate whether modifications to technology are needed to provide incremental data or calculations.
	  ◦ Review and approve the following for each contract type:
	    ▪ Accounting under ASC 606.
	    ▪ Accounting calculation logic.
	    ▪ Journal entries for appropriate financial statement periods.
	    ▪ Updated process flow diagrams.
	    ▪ Technology modification requests.
	• Discuss any challenges identified with external auditors for continuous feedback.

(Table continued)

Activities	Key Actions
Technical Accounting	
Develop accounting policy documentation	• Evaluate primary accounting issues, and research relevant requirements for tentative conclusions. • Evaluate the accounting impact of complex arrangements, and draft related whitepapers. • Develop accounting policy and position documentation, and share with external auditors for continuous feedback.
Finalize transition plan	• Draft illustrative impact on financial statements and key metrics. • Establish implementation timelines across all regions and sectors, including: ◦ Identifying resource requirements and resources to fulfill those requirements. ◦ Identifying key milestones and dates for meeting those milestones. • Communicate implementation timeline across all regions and sectors, and finalize timeline for implementation.
Data and System Development	
Determine data retention and strategy	• Identify data gaps and related data to be tracked and retained for accounting purposes upon standard implementation. • Communicate data tracking and retention requirements to all offices and regions. • Develop processes and controls to ensure that data that are being collected and maintained are complete and usable.
Identify systems architecture options	• Coordinate with IT and finance to understand requirements locally and across all regions and business units. • Identify key data sources. • Perform data gap analysis and sourcing of key data. • Consider alternatives to start storing key data for future accounting before systems development is completed. • Evaluate impact of data volume and calculation requirements on database architecture. • Identify preliminary solution recommendation that contemplates all regions and business units.
Develop accounting rules and business requirements	• Develop business requirement document. • Review functional and business specifications with IT. • Prepare functional and technical design document for solution building and development. • Design artifacts development, including application interface. • Conduct business reviews of design and architecture deliverables.

(Table continued)

Activities	Key Actions
Process/Close, Consolidate, and Report	
Consider current disclosures	Determine necessary disclosures under SAB Topic 11.M.[2]
Design infrequent event controls	• Design controls to address risks of material misstatement arising from the adoption of the new revenue standard. • Reevaluate the design of existing controls that address the risks of material misstatement related to the revenue assertions, as applicable.
Tax Compliance and Accounting	
Evaluate tax reporting requirements	• Review sample accounting calculation logic, journal entries, and other analytical reports from contract evaluations. • Identify specific tax reporting requirements across all regions and business units. • Evaluate tax filing and reporting implications of revenue changes. • Document tax conclusions and tax accounting policies. • Develop a plan for tax data maintenance, and document tax data flows. • Evaluate potential integration issues and possible modification needs with tax accounting systems. • Integrate tax requirements into overall transition plan.
Readiness and Training	
Develop training sessions	• Identify audience, timing, frequency, and duration of training. • Develop training plan and materials. • Tailor training material for different business needs and audiences.
Program Management and Communications	
Update steering committee	• Conduct periodic status meetings with key project personnel. • Provide periodic status reports. • Provide overview of significant accounting, financial reporting, and system impact and changes under the new revenue standard. • Periodically update project overview and progress: ◦ Management against work plan. ◦ Discussion and remediation of risks. • Stay up to date on the issues being deliberated by the FASB, TRG, SEC, PCAOB, AICPA, EITF, and relevant industry task forces. • Participate in industry roundtables to understand how industry-specific issues are being addressed. • Conduct periodic status meetings with external auditors, those charged with governance (e.g., the audit committee, board of directors), and other constituents, as applicable.

[2] See footnote 1.

Implementation

Activities	Key Actions
Risk Assessment	
Perform risk assessment	Perform risk assessment related to the adoption of the new revenue standard throughout the adoption activities.
Technical Accounting	
Auditor review of accounting policies, contract evaluations, and implementation approach	• Review contract evaluations with external auditors. • Obtain auditor review of contract evaluations, direct incremental cost evaluations, accounting policy, and position documentation. • Obtain auditor feedback on implementation approach. • Discuss approach to testing modifications/implementation of revenue accounting systems.
Draft disclosures	• Determine necessary disclosures under SAB Topic 11.M.[3] • Draft disclosure information for reporting that contemplates requirements related to the new revenue standard and SEC reporting, as applicable.
Data and System Development	
Execute data retention strategy	• Execute data retention strategy. • Store and maintain key data as of [date to be determined by entity] in case contract data are needed to modify contract evaluations on a subsequent date.
Develop accounting rules	• Develop accounting rules for modifications/implementation of IT system(s) to recognize revenue in accordance with the new standard on the basis of contract evaluations. • Establish and develop an appropriate data repository. • Develop appropriate reconciliation reports and controls. • Determine key user reports, journal entries, and other reports.

[3] See footnote 1.

(Table continued)

Activities	Key Actions
Data and System Development	
Test accounting rules	Test modifications made to accounting systems or implementation(s) of new revenue accounting system, and remediate any identified errors.
Deployment	• Deploy system into production. • Run portfolio reports to facilitate debugging, reconciliations, and remediation.
Post-implementation review	Run/test dual reporting functionality to debug in advance of the standard's effective date.
Process/Close, Consolidate, and Report	
Consider current disclosures	Determine necessary disclosures under SAB Topic 11.M.[4]
Monthly close processes/staffing	• Identify additional steps required in periodic closing process on the basis of the system functionality implemented. • Evaluate (1) additional processes and resource needs and (2) revised job requirements. • Define systems/data needs or customized reports to support periodic management and corporate reporting purposes, including review cycles. • Document periodic reporting policy and procedure.
Control implementation review	• Document reporting processes and procedures related to new revenue calculations and reports. • Review operation of key controls, processes, and reports on potential improvement. • Perform ongoing evaluation and remediation efforts on the basis of feedback from the steering committee and key project personnel (e.g., finance, financial reporting, tax, IT, internal audit, external auditors).
Tax Compliance and Accounting	
Tax reporting implementation	• Develop testing procedures for system integration. • Evaluate system solution for adequacy in addressing accounting and reporting needs under the new revenue standard. • Test modifications/implementation of IT system(s) and error remediation for revised tax reporting requirements. • Develop and execute tax training session.
Readiness and Training	
Training rollout	• Execute training sessions. • Perform ongoing enhancements to training materials, as necessary.

[4] See footnote 1.

(Table continued)

Activities	Key Actions
Program Management	

Update steering committee	• Conduct periodic status meetings with key project personnel.
	• Provide periodic status reports.
	• Provide overview of significant accounting, financial reporting, and system impact and changes under the new revenue standard.
	• Periodically update project overview and progress:
	  ◦ Management against work plan.
	  ◦ Discussion and remediation of risks.
	• Stay up to date on the issues being deliberated by the FASB, TRG, SEC, PCAOB, AICPA, EITF, and relevant industry task forces.
	• Participate in industry roundtables to understand how industry-specific issues are being addressed.
	• Conduct periodic status meetings with external auditors, those charged with governance (e.g., the audit committee, board of directors), and other constituents, as applicable.

Sustainability

The following items are general descriptions of activities to perform after adoption of the new revenue standard is complete:

- Perform post-“go-live” assessments of system implementation or upgrades.
- Have Internal Audit perform tests of operating effectiveness of changed or newly implemented internal controls:
  - *COSO Principle 16* — Are the results of the operating effectiveness of internal controls being actively monitored?
  - *COSO Principle 17* — Are identified control deficiencies being evaluated, communicated, and remediated?
- Review comparable entities’ issued Forms 10-Q and 10-K, time permitting, to identify potential modifications to disclosures.
- Issue Forms 10-Q and 10-K with expanded disclosures.

Appendix G — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

AICPA Statements of Position (SOPs)

97-2, "Software Revenue Recognition"

81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts"

00-2, "Accounting by Producers or Distributors of Films" (superseded)

FASB Accounting Standards Updates (ASUs)

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross versus Net)*

ASU 2016-02, *Leases (Topic 842)*

ASU 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*

ASU 2015-02, *Consolidation (Topic 810)*

ASU 2014-09, *Revenue From Contracts With Customers*

ASU 2013-12, *Definition of a Public Business Entity — An Addition to the Master Glossary*

FASB Accounting Standards Codification (ASC) Topics

ASC 210, *Balance Sheet*

ASC 210-20, *Balance Sheet: Offsetting*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 310-20, *Receivables: Nonrefundable Fees and Other Costs*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 325, *Investments — Other*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 340-40, *Other Assets and Deferred Costs: Contracts With Customers*

ASC 350, *Intangibles — Goodwill and Other*

ASC 350-40, *Intangibles — Goodwill and Other: Internal-Use Software*

ASC 360, *Property, Plant, and Equipment*

ASC 360-20, *Property, Plant, and Equipment: Real Estate Sales*

ASC 405, *Liabilities*

ASC 450, *Contingencies*

ASC 450-20, *Contingencies: Loss Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 605, *Revenue Recognition*

ASC 605-20, *Revenue Recognition: Services*

ASC 605-25, *Multiple-Element Arrangements*

ASC 605-35, *Revenue Recognition: Construction-Type and Production-Type Contracts*

ASC 605-50, *Revenue Recognition: Customer Payments and Incentives*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 610-20, *Other Income: Gains and Losses From the Derecognition of Nonfinancial Assets*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 730, *Research and Development*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 815-40, *Derivatives and Hedging: Contracts in Entity's Own Equity*

ASC 825, *Financial Instruments*

ASC 835, *Interest*

ASC 835-30, *Interest: Imputation of Interest*

ASC 840, *Leases*

ASC 840-50, *Leases: Sale-Leaseback Transactions*

ASC 842, *Leases*

ASC 842-20, *Leases: Lessee*

ASC 842-40, *Leases: Sale and Leaseback Transactions*

ASC 845, *Nonmonetary Transactions*

ASC 860, *Transfers and Servicing*

ASC 912, *Contractors — Federal Government*

ASC 912-20, *Contractors — Federal Government: Contract Costs*

ASC 924, *Entertainment — Casinos*

ASC 924-605, *Entertainment — Casinos: Revenue Recognition*

ASC 926-605, *Entertainment — Films: Revenue Recognition*

ASC 932, *Extractive Activities — Oil and Gas*

ASC 942, *Financial Services — Depository and Lending*

ASC 942-825, *Financial Services — Depository and Lending: Financial Instruments*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 946-605, *Financial Services — Investment Companies: Revenue Recognition*

ASC 954, *Health Care Entities*

ASC 954-440, *Health Care Entities: Commitments*

ASC 954-450, *Health Care Entities: Contingencies*

ASC 958, *Not-for-Profit Entities*

ASC 970, *Real Estate — General*

ASC 980, *Regulated Operations*

ASC 980-350, *Regulated Operations: Intangibles — Goodwill and Other*

ASC 985, *Software*

ASC 985-20, *Software: Costs of Software to Be Sold, Leased, or Marketed*

ASC 985-605, *Software: Revenue Recognition*

FASB Proposed Accounting Standards Updates

Proposed ASU 2016-250, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

Proposed ASU 2016-240, *Technical Corrections and Improvements to Update 2014-09, Revenue From Contracts With Customers (Topic 606)*

Proposed ASU 2015-330, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

Proposed ASU 2011-230 (Revised), *Revenue Recognition (Topic 605): Revenue From Contracts With Customers*

FASB Statement of Financial Accounting Standards (Pre-Codification Literature)

No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* — an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17

No. 66, *Accounting for Sales of Real Estate*

No. 45, *Accounting for Franchise Fee Revenue*

No. 5, *Accounting for Contingencies*

FASB Concepts Statements (Pre-Codification Literature)

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 6, *Elements of Financial Statements — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*

FASB Technical Bulletin (Pre-Codification Literature)

FTB 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

EITF Issues (Pre-Codification Literature)

00-10, "Accounting for Shipping and Handling Fees and Costs"

91-9, "Revenue and Expense Recognition for Freight Services in Process"

01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

90-22, "Accounting for Gas-Balancing Arrangements"

Topic D-96, "Accounting for Management Fees Based on a Formula"

SEC Division of Corporation Finance FRM

Topic 2, "Other Financial Statements Required"; Section 2400, "Equity Method Investments, Including Fair Value Option"

Topic 11, "Reporting Issues Related to Adoption of New Revenue Recognition Standard"; Section 11200, "Financial Statements of Other Entities and Significance"

SEC Regulation S-K

Item 301, "Selected Financial Data"

Item 308(c), "Internal Control Over Financial Reporting: Changes in Internal Control Over Financial Reporting"

SEC Regulation S-X

Rule 1-02(w), "Definitions of Terms Used in Regulation S-X: Significant Subsidiary"

Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 4-08(g), "General Notes to Financial Statements: Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 5-03, "Income Statements"

Article 11, "Pro Forma Financial Information"

SEC Staff Accounting Bulletin (SAB) Topics

SAB Topic 1.M, "Materiality"

SAB Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period" (SAB 74)

SAB Topic 13, "Revenue Recognition":

- SAB Topic 13.A.2, "Selected Revenue Recognition Issues: Persuasive Evidence of an Arrangement."
- SAB Topic 13.A.3(a), "Selected Revenue Recognition Issues: Delivery and Performance: Bill and Hold Arrangements."

SAB No. 101, "Revenue Recognition in Financial Statements"

SAB No. 104, "Revenue Recognition, Corrected Copy"

International Standards

IFRS 15, *Revenue From Contracts With Customers*

IFRS 11, *Joint Arrangements*

IFRS 10, *Consolidated Financial Statements*

IFRS 9, *Financial Instruments*

IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*

IAS 39, *Financial Instruments: Recognition and Measurement*

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

IAS 34, *Interim Financial Reporting*

IAS 32, *Financial Instruments: Presentation*

IAS 18, *Revenue*

IAS 11, *Construction Contracts*

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*

IAS 1, *Presentation of Financial Statements*

TRG Agenda Papers

TRG Agenda Paper 1, *Gross Versus Net Revenue*

TRG Agenda Paper 2, *Gross Versus Net Revenue: Amounts Billed to Customers*

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TRG Agenda Paper 15, *Noncash Consideration*

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TRG Agenda Paper 17, *Application of IFRS 15 to Permitted Islamic Finance Transactions*

TRG Agenda Paper 18, *Material Right*

TRG Agenda Paper 19, *Consideration Payable to a Customer*

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Appendix H — Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
B&E	blend-and-extend
BC	Basis for Conclusions
C&DI	SEC Compliance and Disclosure Interpretation
CED	contract establishment date
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ED	exposure draft
EITF	Emerging Issues Task Force
ERP	enterprise resource planning
FAS	FASB Statement of Financial Accounting Standards
FASAC	Federal Accounting Standards Advisory Council
FASB	Financial Accounting Standards Board
FOB	free on board
FRM	SEC Financial Reporting Manual
GAAP	generally accepted accounting principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board

Abbreviation	Description
ICFR	internal control over financial reporting
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
IOSCO	International Organization of Securities Commissions
IP	intellectual property
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IT	information technology
OCA	SEC's Office of the Chief Accountant
OEM	original equipment manufacturer
P&U	power and utilities
PCAOB	Public Company Accounting Oversight Board
PCS	postcontract customer support
Q&A	question and answer
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission
SOP	AICPA Statement of Position
SSP	stand-alone selling price
TRG	FASB/IASB transition resource group for revenue recognition
VSOE	vendor-specific objective evidence

Deloitte.

Real Estate

Accounting and Financial Reporting Update

December 2, 2016

Contents

Foreword

December 2, 2016

To our clients and colleagues in the real estate sector:

We are pleased to announce our ninth annual accounting and financial reporting update. Some of the notable standard-setting developments that occurred since the previous edition were the issuance of (1) new guidance on the accounting for leases and the impairment of financial instruments, (2) new guidance to clarify the classification of certain cash receipts and payments in the statement of cash flows, and (3) refinements to the FASB's new guidance on the recognition of revenue from contracts with customers.

This publication is divided into three sections: (1) "Updates to Guidance," which highlights changes to accounting and reporting standards that real estate entities need to start preparing for now; (2) "On the Horizon," which discusses standard-setting topics that will affect real estate entities as they plan for the future; and (3) "Other Topics" that may be of interest to entities in the real estate sector.

The annual accounting and financial reporting updates for the banking and securities, insurance, and investment management sectors are available (or will be available soon) on US GAAP Plus, Deloitte's Web site for accounting and financial reporting news.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

Sincerely,

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Introduction

The real estate market continued its modest recovery from 2013 through 2016, but it may be approaching the peak of the recovery cycle. Looking ahead, we believe that the impact of financial regulations under the Dodd Frank Act and Basel III will likely create a challenging financing environment for many individuals looking to invest in real estate. Higher interest rates and risk are expected outcomes of the new regulations. Through the third quarter of 2016, the national home price index gained single-digit year-to-date returns compared with double-digit growth in 2013. We can expect this growth to further decrease as interest rates increase.

Accounting Changes

In February 2016, after working many years on a new lease accounting standard, the FASB issued ASU 2016-02. The guidance is intended to address concerns related to off-balance sheet financing, as it brings most leases onto the balance sheets of lessees. From a lessor perspective, accounting for lease revenue will essentially be unchanged under the new standard, and most real estate leases will continue to be classified as operating leases.

In June 2016, the FASB issued ASU 2016-13, which provides guidance on the impairment of financial instruments. The ASU introduces the current expected credit loss model, which is an impairment model based on expected rather than incurred losses. This new impairment model is intended to result in more timely recognition of impairment losses since it requires an entity to recognize its estimate of expected credit losses at the earliest reporting date such expectations arise.

In August 2016, the FASB issued ASU 2016-15, which adds clarifying guidance on the classification of certain cash payments and receipts on the statement of cash flows. This guidance was based on a project of the FASB's Emerging Issues Task Force (EITF) that focused on eight types of cash flows including (1) debt prepayment or debt extinguishment costs, (2) settlement of zero-coupon bonds, (3) contingent consideration payments made after a business combination, (4) proceeds from the settlement of insurance claims, and (5) distributions received from equity method investees. The purpose of this project was to reduce diversity in practice and provide specific guidance for classification of these cash flows.

In November 2016, the FASB issued ASU 2016-18, which amends ASC 230 to clarify the guidance on the classification and presentation of restricted cash. The ASU was based on consensuses reached by the EITF.

The FASB is also currently working on projects that real estate entities should continue to monitor, including (1) clarifying the definition of a business, (2) clarifying the scope of asset derecognition in transactions with non-customers, (3) accounting for partial sales of nonfinancial assets, and (4) hedging of financial instruments.

For additional information about industry issues and trends, see Deloitte's *2016 Financial Services Industry Outlooks*.

Updates to Guidance

Revenue Recognition

Background

In May 2014, the FASB issued ASU 2014-09, which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance (e.g., certain sections of ASC 360-20 and ASC 970-605). For additional information about ASU 2014-09 as issued, see Deloitte's May 28, 2014, *Heads Up* and July 2014 *Financial Services Spotlight*.

In response to concerns the FASB received related to applying the ASU's requirements, the Board in 2016 issued the following four ASUs, which amend the ASU's new revenue recognition guidance:

- *ASU 2016-08,* Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net) — The ASU addresses issues related to how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. The amendments provide guidance on (1) how to determine the unit of account, (2) whether the indicators in ASU 2014-09 are intended to help entities perform a single evaluation of control or represent an additional evaluation, and (3) how certain indicators are related to the general control principle. The ASU also clarifies that an entity should evaluate whether it is the principal or the agent for each good or service specified in a contract and thus whether an entity could be both the principal and agent for different performance obligations in the same contract. See Deloitte's March 22, 2016, *Heads Up* for more information.
- *ASU 2016-10,* Identifying Performance Obligations and Licensing — The ASU's amendments clarify the guidance on an entity's identification of certain performance obligations. Changes include guidance on immaterial promised goods and services and separately identifiable promises as well as (1) a policy election for shipping and handling fees incurred after control transfers and (2) clarifications related to licenses. See Deloitte's April 15, 2016, *Heads Up* for more information.
- *ASU 2016-11,* Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update) — The ASU rescinds the following guidance, which is based on announcements made by the SEC staff at the Emerging Issues Task Force's (EITF's) March 3, 2016, meeting, upon an entity's adoption of ASU 2014-09:
  - Revenue and expense recognition for freight services in process (ASC 605-20-S99-2).
  - Accounting for shipping and handling fees and costs (ASC 605-45-S99-1).
  - Accounting for consideration given by a vendor to a customer (ASC 605-50-S99-1).
  - Accounting for gas-balancing arrangements (ASC 932-10-S99-5).

- *ASU 2016-12,* Narrow-Scope Improvements and Practical Expedients — The guidance (1) clarifies how to assess whether collectibility is probable in certain circumstances to support the existence of a contract, (2) adds a practical expedient for the presentation of sales taxes on a net basis in revenue, (3) clarifies how to account for noncash consideration at contract inception and throughout the contract period, and (4) establishes a practical expedient to address contract modifications upon transition. See Deloitte's May 11, 2016, ***Heads Up*** for more information.

In addition to the ASUs above, the FASB on May 18, 2016, and September 19, 2016, issued proposed ASUs that would make technical corrections (i.e., minor changes and improvements) to certain aspects of ASU 2014-09 related to the following topics:

- *Contract costs — impairment testing* — The proposed amendments "would clarify that when performing impairment testing an entity should (a) consider expected contract renewals and extensions and (b) include both the amount of consideration it already has received but has not recognized as revenue and the amount the entity expects to receive in the future."
- *Disclosure of remaining performance obligations* — The proposed amendments would (1) "provide practical expedients to the disclosure requirement for remaining performance obligations for specific situations in which an entity need not estimate variable consideration in order to recognize revenue" and (2) "expand the information disclosed when an entity applies one of the practical expedients."
- *Contract modifications example* — The proposed amendments "would improve the alignment of Example 7 and the [contract modifications] principles in Topic 606."
- *Cost capitalization for advisers to private and public funds* — The proposed amendments "would align the cost-capitalization guidance for advisors to both public funds and private funds in Topic 946."
- *Loan guarantee fees* — The proposed amendments "would clarify that guarantee fees within the scope of Topic 460 (other than product or service warranties) are not within the scope of Topic 606."
- *Contract asset versus receivable* — The proposed amendments "would provide a better link between the analysis in Example 38, Case B and the receivables presentation guidance in Topic 606."
- *Advertising costs* — The proposed amendments "would reinstate the guidance on the accrual of advertising costs."

The amendments are being proposed in response to feedback received from several sources, including the transition resource group (TRG) for revenue recognition, and would clarify, rather than change, the new revenue standard's core revenue recognition principles. The Board discussed the proposed technical corrections at its August 31, 2016, and October 19, 2016, meetings. See Deloitte's September 1, 2016, and October 21, 2016, journal entries for more information on the Board's discussions.

Thinking It Through

ASU 2014-09 will significantly affect the accounting for real estate sales. The ASU eliminates the bright-line guidance that entities currently apply under ASC 360-20 when evaluating when to derecognize real estate assets and how to measure the profit on the disposal. It will change the accounting for both real estate sales that are part of an entity's ordinary activities (i.e., real estate transactions with customers) and real estate sales that are not part of the entity's ordinary activities. While the ASU eliminates the guidance in ASC 360-20 on real estate sales, entities will still need to apply ASC 360-20 to sales of real estate that are part of sale-leaseback transactions until their adoption of the new leasing standard.

Key Accounting Issues

Some of the key accounting issues and potential challenges as a result of the new revenue guidance are discussed below.

Financing Arrangements (Existence of a Contract)

Under current guidance, when the seller of real estate also provides financing to the buyer, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

Under ASU 2014-09, an entity will need to evaluate several criteria to determine whether a contract exists. One particularly challenging criterion related to evaluating whether a real estate contract exists is that it must be "probable that the entity will collect the consideration to which it will be entitled." To make this determination, the entity should consider the buyer's ability and intention to pay the amount of consideration when it is due. The ASU does not retain the specific initial and continuing investment thresholds under current U.S. GAAP for performing this evaluation; however, some factors to consider may include the loan-to-value ratio of the property and the purchaser's intended use of the property.

Thinking It Through

The collectibility criterion should be evaluated on the basis of the amount to which the entity expects to be entitled, which may not be the stated transaction price. For example, these two amounts may differ because an entity anticipates offering the customer a price concession. Accordingly, entities should carefully assess the facts and circumstances to determine whether, on the basis of their assessment of the customer's credit risk (for example), they expect to grant a price concession.

If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under the ASU's criteria. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would evaluate the arrangement under the derecognition criteria in the ASU. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received as a gain.

Identifying Performance Obligations

Sometimes, a seller remains involved with property that has been sold (e.g., by providing additional services such as construction or development activities). Under current guidance, profit is generally deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under the ASU, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a "separate performance obligation," constitutes a guarantee, or prevents the transfer of control.[1] Goods and services are distinct (and considered separate performance obligations) if the two criteria in ASC 606-10-25-19 are met, including the requirement that goods or services are distinct in the context of the contract. Alternatively, an entity would bundle goods or services until they are distinct. Further, ASC 606-10-25-21 provides guidance on when goods or services would be distinct in the context of the contract. If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized as revenue when (or as) the entity transfers the related good or service to the customer.

Thinking It Through

After the issuance of ASU 2014-09, stakeholders questioned how real estate developers should account for contracts under which it is expected that certain amenities or common areas will be provided in a community development (to be owned either by a homeowners association or by the local municipality). Some stakeholders believed that a developer that intends to provide common areas (e.g., a community center, parks, tennis courts) to a homeowners association as part of a development would generally not consider such an arrangement to represent a promise to deliver goods or services in the separate contract to sell the real estate (e.g., a single-family home) to its other customers. That is, the agreement with the homeowners association would not be combined with the agreement to sell the real estate to a separate customer. Therefore, the arrangement with the homeowners association to provide the common areas would not be considered a performance obligation in the real estate contract with the separate customer. Others, however, believed that arrangements to develop common areas are separate performance obligations in the real estate contract with the customer to which a portion of the consideration received for the sale of real estate would be allocated and deferred until control of the common areas transfers to the homeowners association. As part of implementation activities, the industry discussed this situation with standard setters and others to establish consistent application of the revenue standard. It is our understanding that the FASB did not intend to change current practice related to these activities (i.e., generally the provision of common area items to a homeowners association would not constitute separate performance obligations). Note that the ASU did not amend the guidance in ASC 970 that requires a developer to use a cost accrual approach upon sale of the real estate to account for costs of the common areas.

[1] Certain forms of continuing involvement would not constitute a separate performance obligation. For example, an option or obligation to repurchase a property is specifically addressed by the ASU and would preclude derecognition of the property. Further, a seller obligation that qualifies as a guarantee under ASC 460 would be outside the scope of the ASU.

Contracts with entities in the real estate industry — such as construction and engineering entities — often include deliverables that are completed over a number of phases. Such phases often are engineering, design, procurement, and construction of a facility or project. Stakeholders have raised questions and have had differing views about whether phases of a project (e.g., in typical design-and-build contracts) are distinct performance obligations or part of one combined performance obligation because they may not be distinct in the context of the contract.

Thinking It Through

Under the new standard, it may be difficult to assess whether phases of engineering, design, procurement, and construction are part of one combined performance obligation (e.g., because the phases are highly dependent and highly interrelated or part of a significant service of integration) or are distinct performance obligations. Such difficulty may also affect the way revenue is recognized (e.g., point in time or over time and the measure of progress if revenue is recognized over time). Accordingly, entities will need to exercise significant judgment and consider the specific facts and circumstances of each contract. Entities are also encouraged to monitor the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force implementation activities, particularly the working draft of the implementation paper that addresses the identification of performance obligations. The working draft, which was exposed for public comment in July 2016, indicates that, when identifying performance obligations, entities should consider the following:

- "[T]he risk the entity assumes in performing the integration service [and whether that risk] is inseparable from the risk relating to the transfer of the other promised goods or services."
- "[W]hether the integration service is significant."

The working draft also contains an example illustrating the identification of performance obligations for a "design, build and maintenance contract," which entities may find helpful.

Determining the Transaction Price

Under the new revenue standard, the determination of the transaction price includes an assessment of not only the stated contract price but also future events (e.g., exercise of contract options, issuance of change orders, filing of claims or incurrence of penalty or incentive payments). For example, a sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. Any additional revenue would be recorded only when the contingent revenue is realized. Under the ASU, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (the "constraint").

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price, which may be recognized up front. As a result, revenue may be recognized earlier under the ASU than under current requirements.

The working draft of the implementation paper issued by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force provides insights on evaluating variable consideration and includes several illustrative examples.

The ASU also requires entities to adjust the transaction price for the time value of money when the arrangement gives either the buyer or the seller a significant benefit of financing the transfer of real estate to the buyer. In such instances, the seller will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the buyer had paid cash for the promised property at the time control was transferred to the buyer. In calculating the amount of consideration attributable to the significant financing component, the seller should use an interest rate that reflects a hypothetical financing-only transaction between the seller and the buyer. As a practical expedient, the ASU does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all the payments and the transfer of the promised goods and services is one year or less.

Accordingly, if an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the buyer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the buyer or the seller a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the seller or the buyer).

Recognizing Revenue When (or as) Performance Obligations Are Satisfied

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer.

Under the ASU, a seller of real estate would evaluate whether a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying assets is transferred to the purchaser.[2] An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred. If control is transferred at a point in time, revenue is recognized when the good or service is transferred.

Under ASU 2014-09, control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "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."

The working draft of the implementation paper issued by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force addresses acceptable measures of progress for contracts that meet the criteria for over-time revenue recognition. Selecting a measure of progress is not a free choice but requires an entity to select the measure that most appropriately depicts the pattern of transfer. Accordingly, the paper describes several attribution models and gives examples of when the use such models may be appropriate.

[2] ASC 606-10-25-25 (added by the ASU) states that "[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

Thinking It Through

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. ASU 2014-09 contains an example[3] in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete. In one scenario in this example, the seller does recognize revenue over time; however, the example indicates that this conclusion is based on legal precedent in the particular jurisdiction where the contract is enforceable.

If a performance obligation does not meet any of the three criteria for recognition over time, it is deemed satisfied at a point in time. Under ASU 2014-09, entities would consider the following indicators in evaluating the point in time at which control of real estate has been transferred to the buyer and when revenue should be recognized:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

While entities will be required to determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP, the FASB decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under the ASU.[4]

Contract Modifications and Claims

Real estate entities that are involved with construction and engineering projects should consider how the ASU may affect the accounting for contract modifications, including unpriced change orders and claims. Examples of items that an entity will need to carefully assess before recognizing revenue related to such modifications include whether (1) the customer has approved scope or price changes and (2) the entity has an enforceable right to additional consideration (i.e., whether it has a legal basis for its claim). Examples such as these may indicate that the entity should include the change order or claim in its transaction price (i.e., as variable consideration under step 3 of the new revenue model) to the extent that it is probable that such an amount is not subject to significant revenue reversal in the future (i.e., the variable consideration constraint).

[3] ASC 606-10-55-173 through 55-182.

[4] An entity would not consider parts of a contract that are accounted for under guidance outside the ASU (e.g., guarantees within the scope of ASC 460) when determining whether control of the remaining goods and services in the contract has been transferred to a customer.

Thinking It Through

As a result of the ASU, revenue related to claims and unapproved change orders may be accelerated.

Other issues that are often subject to significant judgment under the ASU and may result in a change from current practice for real estate entities (particularly engineering and construction entities) include (1) the treatment of uninstalled materials; (2) gross versus net presentation of revenue (i.e., whether an entity is the principal or agent in a transaction with three or more parties); (3) the identification and recording of significant financing components (i.e., time value of money considerations) and warranties; (4) application of variable consideration guidance to milestone payments and what are commonly referred to in the real estate industry as "extras," "add-ons," and "back charges"; and (5) the types and amounts of costs that would meet the recognition criteria for capitalizing precontract costs.

These and other issues are the subject of several papers that have been written by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force. A list of all of the issues currently on the task force's agenda for discussion and their respective statuses is available on the AICPA's Web site, which also contains the working drafts of the implementation papers discussed above.

Effective Date and Transition

In August 2015, as a result of stakeholder concerns, the FASB issued ASU 2015-14, which delays the effective date of ASU 2014-09. Accordingly, the ASU is effective for public business entities for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods.

For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the standard as of the following:

- Annual reporting periods beginning after December 15, 2016, including interim periods.
- Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the annual reporting period of initial application of the new standard.

Implementation and Transition Activities

A number of groups are involved in implementation activities related to the new standard, including the TRG (see Deloitte's *TRG Snapshot* newsletters), the AICPA's revenue recognition task forces, various firms, the SEC,[5] and the PCAOB. Preparers should continue to monitor the activities of these groups before adoption of the new guidance. See Deloitte's January 14, 2016, *Heads Up* for additional adoption and transition observations.

[5] The SEC has indicated that it plans to review and update the revenue recognition guidance in SAB Topic 13 in light of the ASU. The extent to which the ASU's guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Thinking It Through

Real estate entities will need to reassess their historical accounting for all real estate disposals and construction contracts to determine whether any changes are necessary. Further, they will need to consider the guidance in ASU 2014-09 when accounting for repurchase options (the seller may be required to account for the transaction as a lease, a financing, or a sale with a right of return) as well as any guidance issued as a result of the FASB's project on partial sales (i.e., phase 2 of the Board's project on clarifying the definition of a business). In that project, the FASB has tentatively decided that any retained noncontrolling interest in a partial sale would be recorded at fair value and that the unit of account in the evaluation of whether control has transferred in a partial sale would be the underlying asset (see the FASB's project update page for more information). In addition, entities will most likely be required to dual track revenue balances during the transition period, given the potential difficulty associated with retroactively recalculating revenue balances when the ASU becomes effective.

Under the ASU, entities must also provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information, regarding (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, entities used in applying the revenue model; (3) the assets recognized from costs to obtain or fulfill a contract with a customer; and (4) information about unsatisfied performance obligations, including (a) "the aggregate amount of the transaction price allocated to the [unsatisfied] performance obligations" and (b) "an explanation of when the entity expect[ed] to recognize" that amount as revenue. To comply with the ASU's new accounting and disclosure requirements, real estate entities may want to consider whether they need to modify their systems, processes, and controls for gathering and reviewing information that may not have previously been monitored.

Leases

Background

After working for almost a decade, the FASB issued its new standard on accounting for leases, ASU 2016-02, in February 2016. The primary objective of issuing the new leases standard was to address the off-balance-sheet treatment of lessees' operating leases. The standard's lessee model requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases).

The development of the new leases standard began as a convergence project between the FASB and the IASB. Although the project was a convergence effort and the boards conducted joint deliberations, there are several notable differences between the boards' respective leases standards.[6] One of the more significant differences is related to the classification of a lease. Under the FASB's standard, an entity may classify a lease as either an operating lease or a finance lease. Under the IASB's standard, however, an entity would classify all leases as finance leases.

[6] The IASB issued IFRS 16, *Leases*, in January 2016.

Thinking It Through

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor would continue to account for initial direct costs in a manner consistent with the current requirements. However, the definition of an initial direct cost is more restrictive under the new standard and includes only those costs incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. The definition is consistent with that for incremental cost in the new revenue recognition standard (ASC 606). Thus, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. By contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) would be excluded from the definition. As a result, practice is likely to change for many real estate lessors.

Lease and Nonlease Components

Lessees and lessors are required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the new revenue recognition standard, and lessees would do so on a relative stand-alone price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, the ASU states that as "a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component." The ASU also permits a similar accounting policy election from the lessor perspective, noting that it would "be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components)." However, a lessor would need to consider presentation and the disclosure requirements under other U.S. GAAP, as applicable (e.g., ASU 2014-09).

Thinking It Through

If an amount is identified as a lease component, the amount is included in the measurement of the ROU asset and liability. When evaluating whether an activity should be a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. For example, maintenance services (including common area maintenance services) and utilities paid by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered a part of the lease component because they do not transfer a separate good or service to the lessee.

Lessee Accounting

While the boards agreed that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, they supported different approaches for the lessee's subsequent accounting. The FASB chose a dual-model approach under which a lessee classifies a lease by using criteria similar to the lease classification criteria currently in IAS 17. Under IAS 17, there are no "bright lines" such as those under current U.S. GAAP (e.g., the 90 percent fair value test in ASC 840). For leases that are considered finance leases (many current capital leases are expected to qualify as finance leases), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would recognize interest expense and amortization of the ROU asset, which typically would result in a greater expense during the early years of the lease. For leases that are considered operating leases (many current operating leases are expected to continue to qualify as operating leases), the lessee would recognize a straight-line total lease expense. For both types of leases, the lessee would recognize an ROU asset for its interest in the underlying asset and a corresponding lease liability.

Thinking It Through

Under the FASB's dual-model approach, a lease would be classified as a finance lease if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Each criterion except the last is essentially the same as (but not identical to) the existing lease classification criteria in ASC 840. The FASB decided to revise the criteria by eliminating their bright-line thresholds — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. The elimination of the bright-line thresholds could affect a lease's classification. Also, while the last criterion is new, we generally would not expect it to be met in isolation because a lessor would be likely to structure a lease that compensates for the asset's having no alternative use (thereby satisfying another criterion).

Although the classification criteria are similar to those under current U.S. GAAP, some differences affect the real estate industry. First, the ASU requires entities to account for land and other elements separately unless the effects of not doing so are immaterial. Under current U.S. GAAP, the lease classification of land is evaluated separately from the building if its fair value at lease inception is 25 percent or more of the fair value of the leased property and the lease does not meet either the criteria related to transfer of ownership or the bargain purchase option criterion. This change may result in more bifurcation of real estate leases into separate land and building elements that are required to be evaluated separately for lease classification purposes and accounted for separately.

Lessor Accounting

The boards considered constituent feedback and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach that is similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are similar to current sales-type leases, the lessor would only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

Thinking It Through

The inability to recognize profit on a transaction that would not have qualified as a sale under the new revenue recognition guidance is not likely to significantly affect real estate lessors since they typically do not enter into sales-type leases. However, the effect of the ASU's changes to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. In addition, the new guidance requires real estate lessors to disclose more information.

Effective Date and Transition

ASU 2016-02 is effective for public business entities for annual years beginning after December 15, 2018, including interim periods therein. For all other entities, the standard is effective for annual periods beginning after December 15, 2019, and interim periods thereafter. Early adoption is permitted. Lessees and lessors are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements.

For discussion of additional implementation considerations, see Deloitte's March 1, 2016, *Heads Up* and March 2016 *Real Estate Spotlight* (updated July 2016).

Financial Instruments

Impairment

Background

In June 2016, the FASB issued ASU 2016-13, which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss (CECL) model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which the FASB believes will result in more timely recognition of such losses. The ASU is also intended to reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models that entities use to account for debt instruments.

Once effective (see the "Effective Date" discussion below), the new guidance will significantly change the accounting for credit impairment. Banks and certain asset portfolios (e.g., loans, leases, and debt securities) will need to modify their current processes for establishing an allowance for loan and lease losses and other-than-temporary impairments to ensure that they comply with the ASU's new requirements. To do so, they may need to make changes to their operations and systems associated with credit modeling, regulatory compliance, and technology.

Key provisions of the ASU are discussed below. For additional information, see Deloitte's June 17, 2016, *Heads Up*.

Thinking It Through

In late 2015, the FASB established a TRG for credit losses. Like the TRG for the new revenue recognition standard, the credit losses TRG does not issue guidance but provides feedback to the FASB on potential implementation issues. By analyzing and discussing such issues, the TRG helps the Board determine whether it needs to take further action (e.g., by clarifying or issuing additional guidance).

The CECL Model

Scope

The CECL model applies to most[7] debt instruments (other than those measured at fair value), trade receivables, net investments in leases, reinsurance receivables that result from insurance transactions, financial guarantee contracts,[8] and loan commitments. However, available-for-sale (AFS) debt securities are excluded from the model's scope and will continue to be assessed for impairment under the guidance in ASC 320 (the FASB moved the impairment model for AFS debt securities from ASC 320 to ASC 326-30 and has made limited amendments to the impairment model for AFS debt securities, as discussed below).

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible will be written off in a manner consistent with existing U.S. GAAP.

Thinking It Through

Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the ASU states that "an entity is not required to measure expected credit losses on a financial asset . . . in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the [financial asset's] amortized cost basis is zero." U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it decided to allow an entity to recognize zero credit losses on an asset, but the ASU does not so indicate. Regardless, there are likely to be challenges associated with measuring expected credit losses on financial assets whose risk of loss is low.

[7] The following debt instruments would not be accounted for under the CECL model:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

[8] The CECL model does not apply to financial guarantee contracts that are accounted for as insurance or measured at fair value through net income.

Measurement of Expected Credit Losses

The ASU describes the impairment allowance as a "valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset." An entity can use a number of measurement approaches to determine the impairment allowance. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow method) while others project only future principal losses. Regardless of the measurement method used, an entity's estimate of expected credit losses should reflect those losses occurring over the contractual life of the financial asset.

When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the determination or as an amount embedded in the credit loss experience that it uses to estimate expected credit losses. The entity is not allowed to consider expected extensions of the contractual life unless it reasonably expects to execute a troubled debt restructuring with the borrower by the reporting date.

An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity is able to use historical charge-off rates as a starting point for determining expected credit losses, it has to evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond which the entity can make reasonable and supportable forecasts, the entity reverts to historical credit loss experience.

Thinking It Through

It will most likely be challenging for entities to measure expected credit losses. Further, one-time or recurring costs may be associated with the measurement, some of which may be related to system changes and data collection. While such costs will vary by institution, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

AFS Debt Securities

The CECL model does not apply to AFS debt securities. Instead, the FASB decided to make targeted improvements to the existing other-than-temporary impairment model in ASC 320 for certain AFS debt securities to eliminate the concept of "other than temporary" from that model.[9] Accordingly, the ASU states that an entity:

- Must use an allowance approach (vs. permanently writing down the security's cost basis).
- Must limit the allowance to the amount at which the security's fair value is less than its amortized cost basis.
- May not consider the length of time fair value has been less than amortized cost.
- May not consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

[9] The amendments do not apply to an AFS debt security that an entity intends to sell or will more likely than not be required to sell before the recovery of its amortized cost basis. If an entity intends to sell or will more likely than not be required to sell a security before recovery of its amortized costs basis, the entity would write down the debt security's amortized cost to the debt security's fair value as required under existing U.S. GAAP.

PCD Assets

For purchased financial assets with credit deterioration (PCD assets),[10] the ASU requires an entity's method for measuring expected credit losses to be consistent with its method for measuring expected credit losses for originated and purchased non-credit-deteriorated assets. Upon acquiring a PCD asset, the entity would recognize its allowance for expected credit losses as an adjustment that increases the cost basis of the asset (the "gross-up" approach). After initial recognition of the PCD asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows.

Disclosures

Many of the disclosures required under the ASU are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities must also disclose information about:

- Credit quality.[11]
- Allowances for expected credit losses.
- Policies for determining write-offs.
- Past-due status.
- Nonaccrual status.
- PCD assets.
- Collateral-dependent financial assets.

Effective Date and Transition

For public business entities that meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

For public business entities that do not meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years beginning after December 15, 2021.

In addition, entities are permitted to early adopt the new guidance for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

For most debt instruments, entities must record a cumulative-effect adjustment to the statement of financial position as of the first reporting period in which the guidance is effective. However, the ASU provides instrument-specific transition guidance on other-than-temporarily impaired debt securities, PCD assets, and certain beneficial interests within the scope of ASC 325-40.

[10] The ASU defines PCD assets as "[a]cquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment."

[11] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 and ASC 606 are excluded from these disclosure requirements.

Classification and Measurement

Background

ASU 2016-01 amends the guidance on the classification and measurement of financial instruments. The amendments contain changes related to the following:

- Accounting for equity investments (apart from those that are accounted for under the equity method or those that are consolidated).
- Recognition of changes in fair value attributable to changes in instrument-specific credit risk for financial liabilities for which the fair value option has been elected.
- Disclosure requirements for financial assets and financial liabilities.

The ASU's key provisions are discussed below. For more information, see Deloitte's January 12, 2016, *Heads Up*.

Classification and Measurement of Equity Investments

The amendments will require entities to carry all investments in equity securities at fair value, with changes in fair value recorded through earnings (FVTNI), unless the equity investments are accounted for under the equity method or are consolidated. For equity investments that do not have a readily determinable fair value, the guidance will permit a practicability exception under which the equity investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This practicability exception would not be available to reporting entities that are investment companies or broker-dealers in securities.

An entity that has elected the practicability exception for equity investments that do not have a readily determinable fair value is required to assess whether the equity investment is impaired by qualitatively considering the indicators described in ASC 321-10-35-3. If, on the basis of the qualitative assessment, the equity investment is impaired, an entity would be required to record an impairment equal to the amount by which the carrying value exceeds fair value. The entity should no longer evaluate whether such impairment is other than temporary.

Thinking It Through

Under current U.S. GAAP, marketable equity securities that are not accounted for as equity-method investments are classified as either held for trading, with changes in fair value recognized in earnings, or AFS with changes in fair value recognized in other comprehensive income (OCI). For AFS investments, changes in fair value are accumulated in OCI and not recognized in earnings until the investment is sold or has an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity method investments are measured at cost (less impairment) unless the fair value option is elected. Under the new guidance, since equity securities can no longer be accounted for as AFS or cost method investments and will need to be recorded at FVTNI, real estate entities holding such investments could see more volatility in earnings under the new guidance.

Changes in Fair Value of a Liability Attributed to Changes in Instrument-Specific Credit Risk

For financial liabilities (excluding derivative instruments) for which the fair value option has been elected, the amendments will require an entity to separately recognize in OCI any changes in fair value associated with instrument-specific credit risk. The guidance indicates that the portion of the total change in fair value that exceeds the amount resulting from a change in a base market risk (such as a risk-free interest rate) may be attributable to instrument-specific credit risk, but also acknowledges that there may be other methods an entity may use to determine instrument-specific credit risk.

Changes to Disclosure Requirements

For nonpublic business entities, the amendments eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost. In addition, for such financial instruments, public business entities would not be required to disclose (1) the information related to the methods and significant assumptions used to estimate fair value or (2) a description of the changes in the methods and significant assumptions used to estimate fair value. The guidance also clarifies U.S. GAAP by eliminating the provisions in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments require a public business entity to disclose the fair value in accordance with the exit price notion in ASC 820. In addition, all entities are required to disclose in the notes to the financial statement all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

Effective Date and Transition

For public business entities, the new standard is effective for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, the standard is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption of certain of the standard's provisions is permitted for all entities. Nonpublic business entities are permitted to adopt the standard in accordance with the effective date for public business entities.

Measurement-Period Adjustments

Background

In September 2015, the FASB issued ASU 2015-16, which amended the guidance in ASC 805 on the accounting for measurement-period adjustments. The ASU was issued as part of the FASB's simplification initiative in response to stakeholder feedback that restating prior periods to reflect adjustments made to provisional amounts recognized in a business combination adds cost and complexity to financial reporting but does not significantly improve the usefulness of the information provided to users. Key provisions of the ASU are discussed below. For more information, see Deloitte's September 30, 2015, *Heads Up*.

Key Provisions of the ASU

Under previous guidance, when an acquirer identified an adjustment to provisional amounts during the measurement period, the acquirer was required to revise comparative information for prior periods, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting, as if the accounting for the business combination had been completed as of the acquisition date.

The ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date, must be recorded in the reporting period in which the adjustment amounts are determined rather than retrospectively.

Thinking It Through

Although the ASU changes the accounting for measurement-period adjustments, it does not change the definition of a measurement-period adjustment, which is an adjustment to the amounts provisionally recognized for the consideration transferred, the assets acquired, and the liabilities assumed as a result of "new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date." Errors, information received after the measurement period ends, or information received about events or circumstances that did not exist as of the acquisition date are not measurement-period adjustments.

Disclosure Requirements

The ASU also requires that the acquirer present separately on the face of the income statement, or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.

Effective Date and Transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The ASU must be applied prospectively to adjustments to provisional amounts that occur after the effective date. Early application is permitted for financial statements that have not been issued.

The only disclosures required at transition will be the nature of and reason for the change in accounting principle. An entity should disclose that information in the first annual period of adoption and in the interim periods within the first annual period if there is a measurement-period adjustment during the first annual period in which the changes are effective.

Simplifying the Transition to the Equity Method of Accounting

The FASB issued ASU 2016-07 in March 2016 as part of its simplification initiative. Under the guidance in U.S. GAAP before the ASU's amendments, an investor that meets the conditions for applying the equity method of accounting is required to retrospectively apply such method to all prior periods in which it had historically accounted for the investment under the cost method or as an AFS security. The ASU removes the requirement to retrospectively apply the equity method of accounting. It also requires entities to recognize unrealized holding gains or losses in accumulated other comprehensive income (AOCI) related to an AFS security that becomes eligible for the equity method of accounting in earnings as of the date the investment qualifies for the equity method of accounting.

The guidance is effective for all entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The guidance must be applied prospectively to increases in the level of ownership interest or degree of influence occurring after the ASU's effective date. Early adoption is permitted.

Also as part of its simplification initiative, the FASB issued a proposed ASU in June 2015 that would have eliminated the requirement to separately account for basis differences (i.e., the difference between the cost of an investment and the amount of underlying equity in net assets). The proposed guidance would have also eliminated the requirement for an investor to allocate basis differences to specific assets and liabilities of the investee and account for them accordingly (e.g., additional depreciation for basis differences assigned to tangible assets). However, many commenters on the proposed ASU indicated that eliminating the allocation of basis differences could create different complexities and result in inflated values of investments that would no longer be amortized over time as well as increase the likelihood of impairment in future periods. Accordingly, in May 2016, the FASB decided to remove the project from its agenda because of "insufficient support to change the equity method of accounting."

Thinking It Through

Application of the existing accounting requirements (i.e., before the ASU's amendments) can be particularly onerous because investments are often structured as partnerships or limited liability corporations, which may require use of the equity method at a relatively low ownership percentage, and investments in projects may evolve over time depending on stages of development, investment strategy, or changes in portfolio focus. For public companies, the existing U.S. GAAP requirements have been compounded by the SEC's guidance requiring registrants to provide (1) separate or summarized financial statements for prior periods once the equity method of accounting is applied to a significant investment (see paragraph 2405.5 of the SEC's *Financial Reporting Manual*) or (2) retroactively adjusted annual financial statements reflecting the equity method of accounting if a registration statement is filed after the first quarter in which the change to the equity method of accounting is reported but before the next annual report on Form 10-K is filed (see Topic 13 of the *Financial Reporting Manual*).

Accordingly, the ASU provides welcome relief from complex accounting considerations and SEC reporting requirements related to a transition to the equity method of accounting. However, the new ASU will also introduce new complexities after such transition. For example, application of the new method may result in additional basis differences if the earnings that would have affected the cost basis under existing U.S. GAAP are not recognized retrospectively.

Consolidation — Interests Held Through Related Parties That Are Under Common Control

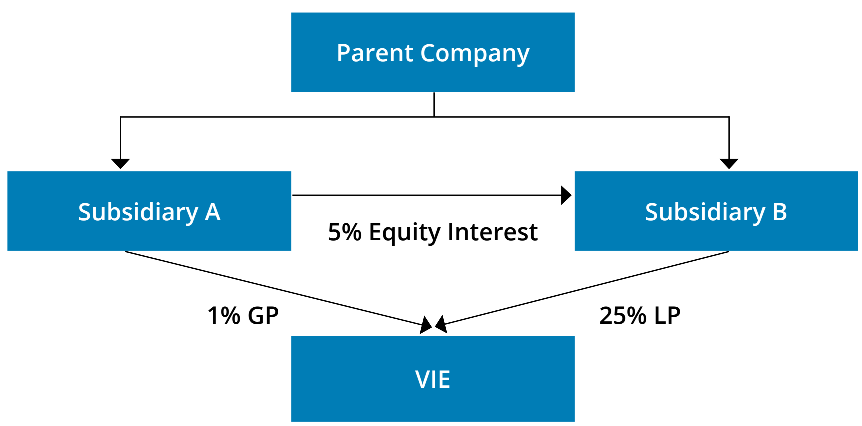
Background

In February 2015, the FASB issued ASU 2015-02, which amends the guidance in ASC 810-10 to require, among other things, a reporting entity that is a single decision maker to consider interests held by its related parties only if the reporting entity has a direct interest in the related parties. If the related parties and the reporting entity are not under common control, the indirect economic interests in a variable interest entity (VIE) held through related parties would be considered on a proportionate basis in the determination of whether the reporting entity is the primary beneficiary of the VIE. Alternatively, if the related parties and the reporting entity are under common control, the reporting entity would be required to consider the interests of the related parties in their entirety (not on a proportionate basis). As a result, the reporting entity may satisfy the "power" criterion (i.e., the ability to direct the activities that most significantly affect the VIE's economic performance) in the consolidation analysis even if it has a relatively insignificant economic interest in the VIE.

In October 2016, the FASB issued ASU 2016-17 to remove the last sentence of ASC 810-10-25-42, which states, "Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety." As a result of the ASU, a reporting entity would consider its indirect economic interests in a VIE held through related parties that are under common control on a proportionate basis in a manner consistent with its consideration of indirect economic interests held through related parties that are not under common control.

Example

A limited partnership (VIE) is formed to acquire a real estate property. The partnership has a GP (Subsidiary A) that holds a 1 percent interest in the partnership, an LP owned by the parent company of the GP (Subsidiary B) that holds a 25 percent interest in the partnership, and various unrelated investors that hold the remaining equity interests. In addition, A holds a 5 percent interest in B, and both A and B are wholly owned subsidiaries of Parent Company. Subsidiary A is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing.



Under the guidance before ASU 2016-17, A and B must consider their own interests before evaluating which entity is the primary beneficiary of the VIE. Accordingly, A would conclude that it meets the power criterion as well as the economics criterion (i.e., the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE) because A must treat B's 25 percent interest in the VIE as its own since A has an interest in B, and both are under the common control of Parent Company.

Example (continued)

Under the ASU, A will still conclude that it meets the power criterion on its own. However, in the evaluation of the economics criterion, since A owns a 20 percent interest in B, and B owns a 5 percent subordinated interest in the VIE, Subsidiary A will conclude that it has a 1 percent indirect interest in the VIE a result of its interest in B (20 percent interest in B multiplied by B's 5 percent interest in the VIE). Therefore, A will be unlikely to meet the economics criterion on its own. However, since A and B are under common control and as a group will satisfy the power and economics criteria, they will need to perform the related-party tiebreaker test to determine which party is most closely associated with the VIE.

Thinking It Through

As a result of the ASU, the related-party tiebreaker test will be performed more frequently because, as illustrated in the example above, it will be less likely for the decision maker to meet the economics criterion on its own when considering its exposure through a related party under common control on a proportionate basis.[12] Many decision makers view the ASU's guidance favorably because they would otherwise consolidate a legal entity with a small indirect interest. The ASU will instead require the decision maker to consider which party (the single decision maker or the related party under common control) is most closely associated with the VIE and therefore should consolidate. This guidance may have a significant impact on the individual financial statements of real estate subsidiaries because it could change which subsidiary consolidates a VIE.

Effective Date and Transition

For all reporting entities, the guidance will be effective for annual periods beginning after December 15, 2016. Reporting entities that have not yet adopted the guidance in ASU 2015-02 will be required to adopt ASU 2016-17's amendments at the same time they adopt those in ASU 2015-02. Early adoption, including adoption in an interim period, is permitted as of October 26, 2016 (the ASU's issuance date).

Employee Share-Based Payment Accounting Improvements

Background

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance, which is part of the Board's simplification initiative, also contains practical expedients for nonpublic entities.

[12] This outcome is because the FASB has proposed to change only the guidance in ASC 810-10-25-42. The Board also considered amending the guidance on determining whether fees paid to a decision maker or service provider represent a variable interest in the evaluation of a decision maker's indirect interests held through related parties under common control. While the proposal would retain that guidance, the Board will consider clarifying it, as well as other aspects of the guidance on common-control arrangements, as part of a separate initiative. The proposal therefore only affects the decision maker's consideration of indirect interests held through related parties under common control in the primary-beneficiary assessment.

Key Provisions of the ASU

Accounting for Income Taxes

Under current guidance, when a share-based payment award is granted to an employee, the fair value of the award is generally recognized over the vesting period, and a corresponding deferred tax asset (DTA) is recognized to the extent that the award is tax-deductible. The tax deduction is generally based on the intrinsic value at the time of exercise (for an option) or on the fair value upon vesting of the award (for restricted stock), and it can be either greater (excess tax benefit) or less (tax deficiency) than the compensation cost recognized in the financial statements. All excess tax benefits are recognized in additional paid-in capital (APIC), and tax deficiencies are recognized either in the income tax provision or in APIC to the extent that there is a sufficient "APIC pool" related to previously recognized excess tax benefits.

Under the ASU, an entity recognizes all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement. This change eliminates the notion of the APIC pool and significantly reduces the complexity and cost of accounting for excess tax benefits and tax deficiencies. In addition, excess tax benefits and tax deficiencies are considered discrete items in the reporting period in which they occur and are not included in the estimate of an entity's annual effective tax rate.

The ASU's guidance on recording excess tax benefits and tax deficiencies in the income statement also has a corresponding effect on the computation of diluted earnings per share (EPS) when an entity applies the treasury stock method. An entity that applies such method under current guidance estimates the excess tax benefits and tax deficiencies to be recognized in APIC in determining the assumed proceeds available to repurchase shares. However, under the ASU, excess tax benefits and tax deficiencies are excluded from the calculation of assumed proceeds since such amounts are recognized in the income statement. In addition, the new guidance affects the accounting for tax benefits of dividends on share-based payment awards, which will now be reflected as income tax expense or benefit in the income statement rather than as an increase to APIC.

Further, the ASU eliminates the requirement to defer recognition of an excess tax benefit until the benefit is realized through a reduction to taxes payable.

In addition to addressing the recognition of excess tax benefits and tax deficiencies, the ASU provides guidance on the related cash flow presentation. Under existing guidance, excess tax benefits are viewed as a financing transaction and are presented as financing activities in the statement of cash flows. However, there is no cash receipt but only a reduction in taxes payable. Therefore, a reclassification is made in the statement of cash flows to reflect a hypothetical inflow in the financing section and a hypothetical outflow from the operating section.

Under the ASU, excess tax benefits no longer represent financing activities since they are recognized in the income statement; therefore, excess tax benefits are not separate cash flows and should be classified as operating activities in the same manner as other cash flows related to income taxes. Accordingly, the ASU eliminates the requirement to reclassify excess tax benefits from operating activities to financing activities.

Accounting for Forfeitures

The ASU allows an entity to elect as an accounting policy either to continue to estimate the total number of awards for which the requisite service period will not be rendered (as currently required) or to account for forfeitures when they occur. This entity-wide accounting policy election only applies to service conditions; for performance conditions, the entity continues to assess the probability that such conditions will be achieved. An entity must also disclose its policy election for forfeitures.

Thinking It Through

An entity that adopts a policy to account for forfeitures as they occur must still estimate forfeitures when an award is (1) modified (the estimate applies to the original award in the measurement of the effects of the modification) and (2) exchanged in a business combination (the estimate applies to the amount attributed to precombination service). However, the accounting policy for forfeitures will apply to the subsequent accounting for awards that are modified or exchanged in a business combination.

Statutory Tax Withholding Requirements

The ASU modifies the current exception to liability classification of an award when an employer uses a net-settlement feature to withhold shares to meet the employer's minimum statutory tax withholding requirement. Currently, the exception only applies when no more than the number of shares necessary for the minimum statutory tax withholding requirement to be met is repurchased or withheld. The new guidance stipulates that the net settlement of an award for statutory tax withholding purposes would not result, by itself, in liability classification of the award provided that the amount withheld for taxes does not exceed the maximum statutory tax rate in the employees' relevant tax jurisdictions.

Further, to eliminate diversity in practice, the ASU requires that cash payments to tax authorities in connection with shares withheld to meet statutory tax withholding requirements be presented as a financing activity in the statement of cash flows because such payments represent an entity's cash outflow to reacquire the entity's shares.

Thinking It Through

Under current guidance, an entity is required to track the minimum statutory tax withholding requirement applicable to each specific award grantee in each applicable jurisdiction if shares are repurchased or withheld. Under the new guidance, the maximum rate is determined on a jurisdiction-by-jurisdiction basis even if that rate exceeds the highest rate applicable to a specific award grantee. However, the classification exception would not apply to entities that do not have a statutory tax withholding obligation; for such entities, any net settlement for tax withholding would result in a liability-classified award.

In addition, an entity may change the terms of its awards related to net settlement for withholding taxes from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. While this change may be made to existing awards, the entity would not be required to account for such a change as a modification. However, this accounting treatment applies only in these narrow circumstances (i.e., solely to change the net-settlement provisions from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate for statutory tax withholding purposes) and should not be analogized to other situations.

Practical Expedients for Nonpublic Entities

Expected-Term Practical Expedient

The ASU allows nonpublic entities to use the simplified method to estimate the expected term for awards (including liability-classified awards measured at fair value) with service or performance conditions that meet certain requirements. Such entities would apply this practical expedient as follows:

- For awards with only a service condition, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term of the award.
- For awards with a performance condition, the estimate of the expected term would depend on whether it is probable that the performance condition will be achieved:
    - If it is probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term.
    - If it is not probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as (1) the contractual term if the award does not contain an explicit service period or (2) the midpoint between the requisite service period and the contractual term if the award does contain an explicit service period.

Intrinsic Value Practical Expedient

The ASU allows nonpublic entities to make a one-time election to switch from fair value measurement to intrinsic value measurement, without demonstrating preferability, for share-based payment awards classified as liabilities.

Nonpublic entities are not allowed to make this election on an ongoing basis after the effective date of the new guidance.

Transition and Related Disclosures

The following table outlines the transition methods for an entity's adoption of ASU 2016-09:

Type	Transition Method
Recognition of excess tax benefits and tax deficiencies (accounting for income taxes)	Prospective
Unrecognized excess tax benefits (accounting for income taxes)	Modified retrospective
Classification of excess tax benefits in the statement of cash flows	Retrospective or prospective
Accounting for forfeitures	Modified retrospective
Classification and statutory tax withholding requirements	Modified retrospective
Classification of employee taxes paid in the statement of cash flows when an employer withholds shares for tax withholding purposes	Retrospective
Nonpublic entity practical expedient for expected term	Prospective
Nonpublic entity practical expedient for intrinsic value	Modified retrospective

Thinking It Through

An entity's prior-year APIC pool is not affected because prior-year excess tax benefits and tax deficiencies have already been recognized in the financial statements, and the recognition of excess tax benefits and tax deficiencies in the income statement is prospective only in the fiscal year of adoption. As a result, there is no reclassification between APIC and retained earnings in the fiscal years before adoption. The modified retrospective transition guidance for taxes only applies to previously unrecognized excess tax benefits outstanding upon adoption of ASU 2016-09 with a cumulative-effect adjustment to retained earnings.

In the period of adoption, entities are required to disclose (1) the nature of and reason for the changes in accounting principle and (2) any cumulative effects of the changes on retained earnings or other components of equity as of the date of adoption.

In addition, because the change in presentation in the statement of cash flows related to excess tax benefits can be applied either prospectively or retrospectively, entities are required to disclose (1) "that prior periods have not been adjusted" if the change is applied prospectively or (2) the "effect of the change on prior periods retrospectively adjusted" if the change is applied retrospectively. For the change in presentation in the statement of cash flows related to statutory tax withholding requirements, entities are required to disclose the "effect of the change on prior periods retrospectively adjusted."

Effective Date

For public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual reporting periods. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual reporting periods beginning after December 15, 2018.

Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance. If early adoption is elected, all amendments in the ASU that apply must be adopted in the same period. In addition, if early adoption is elected in an interim period, any adjustments should be reflected as of the beginning of the annual period that includes that interim period.

Example

Entity A, an SEC registrant, adopts ASU 2016-09 in its third fiscal quarter. Entity A had $50 of excess tax benefits in each quarter in its current fiscal year to date and is not affected by adopting any of the other provisions of ASU 2016-09. In its previously issued financial statements in Form 10-Q, A recognized a total of $100 ($50 in each quarter) of excess tax benefits in APIC. In its third fiscal quarter, the period in which the ASU is adopted, A recognizes $50 of excess tax benefits in its income statement. That is, the quarter-to-date income tax provision will only include the third fiscal quarter excess tax benefits ($50). In addition, the year-to-date income tax provision will include excess tax benefits of $150 to reflect the reversal of the excess tax benefits recognized in APIC for the first two fiscal quarters ($100) and the recognition of those benefits in the income statement in those prior quarters (the $100 in excess tax benefits related to the first and second fiscal quarters are not recognized in the third quarter but are reflected on a recasted basis in the applicable prior quarters). In the quarterly information footnote of its subsequent Form 10-K filing, A will present a schedule reflecting the first and second fiscal quarters' excess tax benefits ($50 each quarter) in the income statement even though these amounts were reported in APIC in previously issued financial statements in Form 10-Q. Finally, A's financial statements in Form 10-Q issued in the year after A's adoption of the ASU will reflect the prior-year quarterly excess tax benefits (i.e., first and second fiscal quarters of the prior year) on a recasted basis in the income statement rather than in APIC.

Classification of Deferred Taxes

Background and Key Provisions

In November 2015, the FASB issued ASU 2015-17, which will require entities to present DTAs and deferred tax liabilities (DTLs) as noncurrent in a classified balance sheet. The ASU simplifies the current guidance, which requires entities to separately present DTAs and DTLs as current and noncurrent in a classified balance sheet.

The project on simplifying the balance sheet presentation of deferred taxes is part of the FASB's simplification initiative. Launched in June 2014, the simplification initiative is intended to improve U.S. GAAP by reducing costs and complexity while maintaining or enhancing the usefulness of the related financial information.

Under current guidance (ASC 740-10-45-4), entities "shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting." Stakeholder feedback indicated that the separate presentation of deferred taxes as current or noncurrent provided little useful information to financial statement users and resulted in additional costs to preparers. Therefore, the FASB issued the ASU to simplify the presentation of deferred taxes in a classified balance sheet. Netting of DTAs and DTLs by tax jurisdiction will still be required under the new guidance.

Noncurrent balance sheet presentation of all deferred taxes eliminates the requirement to allocate a valuation allowance on a pro rata basis between gross current and noncurrent DTAs, which constituents had also identified as an issue contributing to complexity in accounting for income taxes.

Thinking It Through

The ASU will align with the current guidance in IAS 12, which requires entities to present DTAs and DTLs as noncurrent in a classified balance sheet.

The example below compares the classification of DTAs and DTLs under current U.S. GAAP with their classification under the new guidance.

Example

Company ABC has a net DTA of $100 million as of December 31, 20X1, as shown in the table below (amounts in millions):

Balance Sheet as of 12/31/X1	
	DTA/(DTL)
Inventory	$ 50
Net operating loss (NOL) carryforward	350
Fixed assets	(300)
Total DTA/(DTL)	$ 100

Company ABC expects that $100 million of the NOL carryforward will be used in the following year. Below are the current and noncurrent classifications of the DTA/(DTL) as of December 31, 20X1 (amounts in millions):

Description	Current U.S. GAAP Current	Current U.S. GAAP Noncurrent	ASU 2015-17 Current	ASU 2015-17 Noncurrent
Inventory	$ 50			$ 50
NOL carryforward	100	$ 250		350
Fixed assets		(300)		(300)
Total DTA/(DTL)	$ 150	$ (50)	$ 0	$ 100

Effective Date and Transition

The ASU requires the following:

- For public business entities, the ASU will be effective for annual periods beginning after December 15, 2016, and interim periods within those years.
- For entities other than public business entities, the ASU will be effective for annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018.

The Board decided to allow all entities to early adopt the ASU for any interim or annual financial statements that have not been issued. In addition, entities are permitted to apply the amendments either prospectively or retrospectively.

In the period the ASU is adopted, an entity will need to disclose "the nature of and reason for the change in accounting principle." If the new guidance is applied prospectively, the entity should disclose that prior balance sheets were not retrospectively adjusted. However, if the new presentation is applied retrospectively, the entity will need to disclose the quantitative effects of the change on the prior balance sheets presented.

Alternatives for Private Companies

Background

The following guidance (developed in 2014 by the Private Company Council (PCC)) is effective in 2016:

- *Goodwill* — In January 2014, the FASB issued ASU 2014-02, which allows private companies to use a simplified approach to account for goodwill after an acquisition. Under such approach, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. The ASU also eliminates "step 2" of the goodwill impairment test; as a result, an entity would measure goodwill impairment as the excess of the entity's (or reporting unit's) carrying amount over its fair value. An entity that elects the simplified approach should adopt the ASU's guidance prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions) existing as of the beginning of the period of adoption.

The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Hedge accounting* — In January 2014, the FASB issued ASU 2014-03, which gives private companies a simplified method of accounting for certain receive-variable, pay-fixed interest rate swaps used to hedge variable-rate debt. An entity that elects to apply the simplified hedge accounting to a qualifying hedging relationship would continue to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, the entity would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement profile as with a fixed-rate borrowing expense. In addition, the entity is allowed more time to complete its initial hedge documentation. An entity that applies the simplified approach also may elect to measure the related swap at its settlement value rather than at fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Entities that elect the simplified approach should adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte's January 27, 2014, *Heads Up* for more information.
- *Identified intangible assets* — In December 2014, the FASB issued ASU 2014-18, which gives private companies an exemption from having to recognize certain intangible assets for (1) assets acquired in a business combination or (2) investments accounted for under the equity method or upon the adoption of fresh-start accounting. Specifically, an entity would not be required to separately recognize intangible assets for noncompete agreements and certain customer-related intangible assets that arise within the scope of the ASU. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to adopt ASU 2014-02 (see discussion above), resulting in the amortization of goodwill. Entities that elect the alternative should adopt the ASU prospectively to the first eligible transaction within the scope of the ASU that occurs in the annual period beginning after December 15, 2015 (with early adoption permitted), and all transactions thereafter. See Deloitte's December 30, 2014, *Heads Up* for more information.

Changes to Effective Date and Transition Guidance in Certain Private-Company ASUs

In March 2016, the FASB issued ASU 2016-03, which gives private companies a one-time unconditional option to forgo a preferability assessment the first time they elect a PCC accounting alternative within the ASU's scope. However, private companies would still be required to perform a preferability assessment in accordance with ASC 250 for any subsequent change to their accounting policy election in a manner consistent with all accounting policy changes under ASC 250.

The ASU also eliminates the effective dates of PCC accounting alternatives that are within the ASU's scope and extends the transition guidance for such alternatives indefinitely. The new guidance is effective immediately and affects all private companies within the scope of ASU 2014-02 (goodwill), ASU 2014-03 (derivatives and hedging), ASU 2014-07 (common-control leasing arrangements), and ASU 2014-18 (identifiable intangible assets). While the new standard extends the transition guidance in ASU 2014-07 (VIEs) and ASU 2014-18, it does not change the manner in which such guidance is applied. See Deloitte's March 16, 2016, *Heads Up* for more information.

Other Private-Company Matters

Throughout 2016, the PCC has discussed aspects of financial reporting that are complex and costly for private companies, including the application of VIE guidance to common-control arrangements, balance-sheet classification of debt, and liabilities and equity short-term improvements. During its April 2016 meeting, the PCC voted to recommend that the FASB add to its agenda PCC Issue 15-02, "Applying Variable Interest Entity Guidance to Entities Under Common Control."

Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments

Background

In August 2016, the FASB issued ASU 2016-15, which amends ASC 230 to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. ASC 230 lacks consistent principles for evaluating the classification of cash payments and receipts in the statement of cash flows. This has led to diversity in practice and, in certain circumstances, financial statement restatements. Therefore, the FASB issued the ASU with the intent of reducing diversity in practice with respect to eight types of cash flows.

Key Provisions of the ASU

The ASU is a result of consensuses reached by the EITF on issues related to the eight types of cash flows. Key provisions of the amendments are summarized below.

Cash Flow Issues	Amendments
Debt prepayment or debt extinguishment costs	Cash payments for debt prepayment or extinguishment costs (including third-party costs, premiums paid, and other fees paid to lenders) must "be classified as cash outflows for financing activities."
Settlement of zero-coupon bonds	The cash outflows for the settlement of a zero-coupon bond must be bifurcated into operating and financing activities. The portion of the cash payment related to accreted interest should be classified in operating activities, while the portion of the cash payment related to the original proceeds (i.e., the principal) should be classified in financing activities.
Contingent consideration payments made after a business combination	Contingent consideration payments that were not made soon after a business combination (on the basis of the consummation date) must be separated and classified in operating and financing activities. Cash payments up to the amount of the contingent consideration liability recognized as of the acquisition date, including any measurement-period adjustments, should be classified in financing activities, while any excess cash payments should be classified in operating activities.
Proceeds from the settlement of insurance claims	Cash proceeds from the settlement of insurance claims should be classified on the basis of the nature of the loss. For insurance proceeds received in a lump-sum settlement, an entity should determine the classification on the basis of the nature of each loss included in the settlement.
Proceeds from the settlement of corporate-owned life insurance (COLI) policies and bank-owned life insurance (BOLI) policies	Cash proceeds from the settlement of COLI and BOLI polices must be classified in investing activities. However, an entity is permitted, but not required, to align the classification of premium payments on COLI and BOLI policies with the classification of COLI and BOLI proceeds (i.e., payments for premiums may be classified as investing, operating, or a combination thereof).

(Table continued)

<table>
<tr><th>Cash Flow Issues</th><th>Amendments</th></tr>
<tr><td>Distributions received from equity method investees</td><td>An entity is required to make an accounting policy election to classify distributions received from equity method investees under either of the following methods:
Cumulative-earnings approach — Under this approach, distributions are presumed to be returns on investment and classified as operating cash inflows. However, if the cumulative distributions received, less distributions received in prior periods that were determined to be returns of investment, exceed the entity’s cumulative equity in earnings, such excess is a return of capital and should be classified as cash inflows from investing activities.
Nature of the distribution approach — Under this approach, each distribution is evaluated on the basis of the source of the payment and classified as either operating cash inflows or investing cash inflows.
If an entity whose chosen policy is the nature of the distribution approach cannot apply the approach because it does not have enough information to determine the appropriate classification (i.e., the source of the distribution), the entity must apply the cumulative-earnings approach and report a change in accounting principle on a retrospective basis. The entity is required to disclose that a change in accounting principle has occurred as a result of the lack of available information as well as the information required under ASC 250-10-50-2, as applicable.

The amendments do not address equity method investments measured under the fair value option.</td></tr>
<tr><td>Beneficial interests in securitization transactions</td><td>A transferor’s beneficial interests received as proceeds from the securitization of an entity’s financial assets must be disclosed as a noncash activity. Subsequent cash receipts of beneficial interests from the securitization of an entity’s trade receivables must be classified as cash inflows from investing activities.</td></tr>
<tr><td>Separately identifiable cash flows and application of the predominance principle</td><td>The guidance provides a three-step approach for classifying cash receipts and payments that have aspects of more than one class of cash flows:
An entity should first apply specific guidance in U.S. GAAP, if applicable.
If there is no specific guidance related to the cash receipt or payment, an entity should bifurcate the cash payment or receipt into “each separately identifiable source or use [of cash] on the basis of the nature of the underlying cash flows.” Each separately identifiable source or use of cash will be classified as operating, investing, or financing activities by applying the guidance in ASC 230.
If the cash payment or receipt cannot be bifurcated, the entire payment or receipt should be classified as operating, investing, or financing activities on the basis of the activity that is likely to be the predominant source or use of cash.</td></tr>
</table>

Thinking It Through

The FASB's objective in the ASU is to eliminate the diversity in practice related to the classification of certain cash receipts and payments. As a result, there could be significant changes for some entities under the revised guidance, particularly with respect to the issues discussed below.

Settlement of Zero-Coupon Bonds

The lack of guidance on the classification of payments to settle zero-coupon bonds in the statement of cash flows has led to diversity in the classification of the cash payment made by a bond issuer at the settlement of a zero-coupon bond. Some entities bifurcate the settlement payment between the principal (the amount initially received by the entity) and accreted interest. In those situations, the portion of the repayment related to principal is classified in financing activities, and the portion related to accreted interest is classified in operating activities. However, other entities do not bifurcate the settlement payment between principal and accreted interest and present the entire repayment in financing activities.

Under the ASU, entities are required to bifurcate the repayment of zero-coupon bonds into principal and accreted interest, with the principal portion classified in financing activities and the accreted interest portion classified in operating activities. As a result, entities that currently classify the entire repayment of zero-coupon bonds in financing activities will need to identify the portion of such payments that are related to accreted interest and apply the provisions of the ASU accordingly.

Distributions Received From Equity Method Investees

While ASC 230 distinguishes between returns of investment (which should be classified as inflows from investing activities) and returns on investment (which should be classified as inflows from operating activities), it does not prescribe a method for differentiating between the two. With respect to distributions from equity method investees, entities make this determination by applying a cumulative-earnings approach or a nature of the distribution approach. The ASU formalizes each of these methods and allows an entity to choose either one as an accounting policy election.

However, the ASU requires entities that choose the nature of the distribution approach to report a change in accounting principle if the information required under this approach is unavailable with respect to a particular investee. Therefore, while the ASU will not eliminate diversity in practice, entities that are currently applying the nature of the distribution approach should be mindful of the additional information and disclosure requirements under the ASU in electing a method as their accounting policy.

Beneficial Interests in Securitization Transactions

There is no specific guidance in ASC 230 on how to classify cash receipts associated with beneficial interests in securitization transactions. As a result, entities have classified the subsequent cash receipts from payments on beneficial interests obtained by the transferor in a securitization of the transferor's trade receivables as either operating activities or investing activities in the statement of cash flows. Although there is diversity in practice, we believe that entities have predominantly presented cash receipts from payments on a transferor's beneficial interests in securitized trade receivables as a cash inflow from operating activities. Accordingly, the requirement to present such cash receipts as a cash inflow from investing activities could change practice significantly.

Separately Identifiable Cash Flows and Application of the Predominance Principle

ASC 230 acknowledges that certain cash inflows and outflows may have characteristics of more than one cash flow class (e.g., financing, investing, or operating) and states that the "appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item." Although ASC 230 gives examples illustrating the application of the predominance principle, entities often have difficulty applying the guidance.

As a result, when cash flows have aspects of more than one cash flow class, the ASU requires that entities first determine the classification of those cash receipts and payments by applying the specific guidance in ASC 230 and other applicable ASC topics. Further, the ASU notes that "[i]n the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows." The ASU goes on to observe that "[i]n situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use . . . the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item." However, because the ASU does not define the term "separately identifiable" in this context, we believe that challenges may be presented related to identifying separately identifiable cash receipts and payments as well as applying the term "predominant."

Effective Date and Transition

For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption will be permitted for all entities.

Entities must apply the guidance retrospectively to all periods presented but may apply it prospectively if retrospective application would be impracticable.

Restricted Cash

Background

In November 2016, the FASB issued ASU 2016-18, which amends ASC 230 to clarify guidance on the classification and presentation of restricted cash. The ASU is the result of the following consensuses reached by the EITF:

- An entity should include in its cash and cash-equivalent balances in the statement of cash flows those amounts that are deemed to be restricted cash and restricted cash equivalents. The Task Force decided not to define the terms "restricted cash" and "restricted cash equivalents" but observed that an entity should continue to provide appropriate disclosures about its accounting policies pertaining to restricted cash in accordance with other GAAP. The Task Force also observed that any change in accounting policy will need to be assessed under ASC 250.
- A reconciliation between the statement of financial position and the statement of cash flows must be disclosed when the statement of financial position includes more than one line item for cash, cash equivalents, restricted cash, and restricted cash equivalents.

- Changes in restricted cash and restricted cash equivalents that result from transfers between cash, cash equivalents, and restricted cash and restricted cash equivalents should not be presented as cash flow activities in the statement of cash flows.
- An entity with a material balance of amounts generally described as restricted cash and restricted cash equivalents must disclose information about the nature of the restrictions.

Effective Date and Transition

For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for annual periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019. Early adoption of the guidance in the ASU is permitted. A reporting entity will apply the guidance retrospectively.

On the Horizon

Financial Instruments

Hedging

In September 2016, the FASB issued a proposed ASU that would amend the hedge accounting recognition and presentation requirements of ASC 815 to (1) reduce their complexity and simplify their application by preparers and (2) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning those activities with the entity's financial reporting for hedging relationships.

Although the changes proposed by the FASB are significant, constituents also should take note of those aspects of existing hedge accounting that the Board decided to retain. The proposal still would require all hedging relationships to be highly effective. Moreover, an entity would retain the ability to voluntarily dedesignate a hedging relationship, designate certain component risks of the hedged item as the hedged risk, and apply the critical-terms-match method or the shortcut method.

The FASB will determine the effective date of the proposed amendments after it considers constituent feedback; however, it has tentatively determined that earlier application of the proposed amendments will be permitted at the beginning of any fiscal year before the effective date. Comments on the proposal (see Deloitte's comments) were due by November 22, 2016.

The sections below summarize the proposed ASU's key provisions. For additional information about the proposed ASU, see Deloitte's September 14, 2016, *Heads Up*.

Key Proposed Changes to the Hedge Accounting Model

Hedge Documentation and Qualitative Assessments of Hedge Effectiveness

Under the proposed model, an entity would be required to perform an initial prospective quantitative assessment of hedge effectiveness at hedge inception (unless the hedging relationship qualifies for application of one of the expedients that permit an assumption of perfect hedge effectiveness, such as the shortcut method or critical-terms-match method); however, the entity generally would have until its first quarterly hedge effectiveness assessment date (i.e., up to three months) to complete this quantitative assessment. All other hedge documentation still would need to be in place at hedge inception. The entity could elect to perform subsequent prospective and retrospective hedge effectiveness assessments qualitatively if certain criteria are satisfied; however, the entity could be forced to revert to quantitative assessments if, because facts and circumstances have changed, the entity may no longer assert qualitatively that the hedging relationship was and continues to be highly effective. Once an entity is forced to perform a quantitative assessment, it would be prohibited from performing qualitative assessments in future periods.

Cash Flow Hedges of Forecasted Purchases or Sales of Nonfinancial Items

For a forecasted purchase or sale of a nonfinancial item, the proposed model would permit an entity to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk if certain criteria are satisfied. An entity could also hedge exposures arising from a contractually specified component of an agreement to purchase or sell a nonfinancial item for a period that extends beyond the contractual term or when a contract does not yet exist if the qualifying criteria will be met in a future contract and all the other cash flow hedging requirements are met.

Recognition and Presentation of the Effects of Hedging Instruments

The proposed amendments would eliminate the concept of separately recognizing periodic hedge ineffectiveness (although under the mechanics of fair value hedging, economic ineffectiveness would still be reflected in current earnings for those hedges).

For highly effective fair value hedging relationships, all changes in the fair value of the hedging instrument, including any amounts excluded from the assessment of hedge effectiveness, would be recorded in current earnings in the same income statement line as the earnings effect of the hedged item.

For highly effective cash flow hedging relationships, the change in the fair value of the hedging instrument used to assess hedge effectiveness would initially be recorded in OCI and would be reclassified out of AOCI into earnings and presented in the same income statement line as the earnings effect of the hedged item when the hedged item affects earnings. Any amounts excluded from the assessment of hedge effectiveness would be recognized immediately in earnings in the same income statement line as the earnings effect of the hedged item. Furthermore, an entity would immediately reclassify out of AOCI amounts associated with any hedged forecasted transaction whose occurrence is not probable. Such amounts would be presented in current earnings in the same income statement line in which the earnings effect of the hedged item would have been recorded had the hedged forecasted transaction occurred.

For highly effective net investment hedges, the change in the fair value of the hedging instrument used to assess hedge effectiveness would initially be recorded in the cumulative translation adjustment in OCI. When the hedged net investment affects earnings (i.e., upon a sale or liquidation), amounts would be reclassified out of the cumulative translation adjustment and be presented in the same income statement line in which the earnings effect of the net investment is presented. The portion (if any) of the hedging instrument’s change in fair value that is excluded from the hedge effectiveness assessment would be recognized immediately in income (although the income statement presentation would not be prescribed).

Financial Hedging Relationships

For hedges of financial items, the proposed model (1) allows the contractually specified index rate in a variable-rate hedged item to be the designated interest rate risk, (2) retains the existing benchmark interest rate definition for fixed-rate hedged items with minor modifications to eliminate inconsistencies, and (3) designates the SIFMA Municipal Swap index as a permitted benchmark interest rate.

Fair Value Hedges of Interest Rate Risk

Under the proposal, for a fair value hedge of interest rate risk, an entity would be allowed to:

- Designate the change in only the benchmark component of total coupon cash flows attributable to changes in the benchmark interest rate as the hedged risk in a hedge of a fixed-rate financial asset or liability. However, if the current market yield of the hedged item is less than the benchmark interest rate at hedge inception (i.e., a "sub-benchmark" hedge), the entity would be required to use the total contractual coupon cash flows for its calculation.
- Consider, for prepayable financial instruments, only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity in calculating the change in the fair value of the hedged item attributable to interest rate risk.
- Designate as the hedged risk only a portion of the hedged item's term and measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins with the first hedged cash flow and ends with the last hedged cash flow." The hedged item's assumed maturity would be the date on which the last hedged cash flow is due and payable.

Shortcut Method and Critical-Terms-Match Method

The proposal would retain both the shortcut and critical-terms-match methods and provide additional relief for entities applying those methods. It would amend the shortcut accounting requirements to allow an entity to specify, at the inception of the hedging relationship, the quantitative (long-haul) method it will use to assess hedge effectiveness and measure hedge results if it later determines that application of the shortcut method was not or no longer is appropriate. In addition, the proposal would amend certain shortcut-method criteria to allow partial-term fair value hedges to qualify for the shortcut method.

Further, the proposal would expedite an entity's ability to apply the critical-terms-match method to cash flow hedges of groups of forecasted transactions. If all other critical-terms-match criteria were satisfied, such hedges would qualify for the critical-terms-match method if all the forecasted transactions occurred within 31 days of the hedging derivative's maturity.

Disclosure Requirements

The proposed ASU would add new disclosure requirements and amend existing ones. Also, to align the disclosure requirements with the proposed changes to the hedge accounting model, the proposal would remove the requirement for entities to disclose amounts of hedge ineffectiveness. In addition, an entity would be required to provide:

- Tabular disclosure of (1) the total amounts reported in the statement of financial performance for each income and expense line item that is affected by hedging and (2) the effects of hedging on those line items.
- Disclosures about the carrying amounts and cumulative basis adjustments of items designated and qualifying as hedged items in fair value hedges.
- Qualitative disclosures describing (1) quantitative hedging goals, if any, established in developing its hedging objectives and strategies and (2) whether those goals were met.

These disclosures would be required for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented.

Adoption and Transition

Entities would adopt the proposal's provisions by applying a modified retrospective approach to existing hedging relationships as of the adoption date. After adoption, in all interim and annual periods, entities would begin to apply the new accounting and presentation model and provide the new and amended disclosures.

In each annual and interim reporting period in the fiscal year of adoption, entities would also be required to furnish certain disclosures required by ASC 250 about (1) the nature and reason for the change in accounting principle and (2) the cumulative effect of the change on the components of equity or net assets as of the date of adoption.

The proposal also describes (1) specific transition considerations related to the accounting for fair value hedges of interest rate risk, (2) one-time transition elections that allow entities to amend the documentation for existing hedging relationships and to take advantage of the guidance on qualitative assessments and the shortcut method of accounting, and (3) a one-time transition election that allows entities, for certain existing cash flow hedging relationships, to take advantage of the amendments that permit designation of a contractually specified interest rate (for variable-rate instruments) or a contractually specified component (for forecasted purchases or sales of nonfinancial items).

Liabilities and Equity — Targeted Improvements

Background

The FASB added a project to its technical agenda in 2014 to consider making targeted improvements to its guidance on the classification of financial instruments as either liabilities or equity. The objective of the project was to simplify the guidance in existing U.S. GAAP on distinguishing liabilities from equity, which involves the application of numerous complex rules and is one of the most common sources of errors and restatements.

However, the FASB tentatively decided in February 2016 to largely abandon the project after concluding that targeted improvements would not adequately address the pervasive problems related to this topic. Instead, the Board decided to seek feedback on whether it should recommence a comprehensive project on distinguishing liabilities from equity to holistically examine the associated issues. Nevertheless, the FASB issued an Invitation to Comment in August 2016 to determine whether it should undertake such a project. As a result, the Board has tentatively decided to proceed with making targeted improvements related to two narrow issues and is expected to issue a proposed ASU during the first quarter of 2017.

The tentative changes would affect the guidance in U.S. GAAP on:

- The accounting for instruments with "down-round" provisions.
- The indefinite deferral of certain pending content in ASC 480-10.

Down-Round Provisions

Background

A down-round provision is a term in an equity-linked financial instrument (e.g., a freestanding warrant contract or an equity conversion feature embedded within a host debt or equity contract) that triggers a downward adjustment to the instrument's strike price (or conversion price) if the entity issues equity shares at a lower price (or equity-linked financial instruments with a lower strike price) than the instrument's then-current strike price. The purpose of the feature is to protect the instrument's counterparty from future issuances of equity shares at a more favorable price.

Under current U.S. GAAP, a contract (or embedded equity conversion feature) that contains a down-round provision does not qualify as equity because such arrangement precludes a conclusion that the contract is indexed to the entity's own stock under ASC 815-40-15 (as illustrated in ASC 815-40-55-33 and 55-34). As a result, contracts and features that include down-round provisions do not currently qualify for the scope exception from derivative accounting in ASC 815-10 for contracts that are indexed to, and classified in, stockholders' equity. Therefore, freestanding contracts on an entity's own equity that contain a down-round feature and meet the definition of a derivative (including net settlement) are accounted for at fair value with changes in fair value recognized in earnings. Similarly, features embedded in an entity's own equity that contain down-round provisions must be separated and accounted for as derivative instruments at fair value if they meet the bifurcation criteria in ASC 815-15.

Tentative Changes

The tentative changes would apply to issuers of financial instruments (e.g., a warrant or a convertible instrument) with down-round features. Specifically excluded from the scope would be (1) freestanding financial instruments and embedded conversion options that are accounted for at fair value with changes in fair value recognized in earnings (e.g., freestanding and bifurcated embedded derivative instruments within the scope of ASC 815 and debt for which the issuer has elected the fair value option in ASC 825-10) and (2) convertible debt instruments that are separated into liability and equity components (e.g., convertible debt with beneficial conversion features or cash conversion features pursuant to ASC 470-20).

Under the tentative proposed approach, a down-round provision would not preclude an entity from concluding that the instrument or feature that includes the provision is indexed to the entity's own stock. For example, when an entity evaluates whether it is required to classify a freestanding warrant that gives the counterparty the right to acquire the entity's common stock as a liability or equity under ASC 815-40, the existence of the down-round feature would not affect the analysis. If the warrant otherwise meets the condition for equity classification, it would be classified as equity. Similarly, in the analysis of whether an embedded conversion feature in a debt host contract must be bifurcated as an embedded derivative under ASC 815-15, the existence of a down-round provision would not prevent the contract from qualifying for the scope exception in ASC 815-10-15-74 for contracts indexed to an entity's own stock and classified in stockholders' equity.

While instruments that contain down-round features would no longer be expressly precluded from equity classification, such instruments may still not qualify for equity classification for other reasons (e.g., if the issuer could be forced to net cash settle the contract). The classification of instruments as liabilities or equity would not, under the proposal, be dictated by the down-round feature. Instead, the down-round feature would affect the accounting only if it were "triggered" (i.e., the entity issued shares at a price below the strike price). Once the feature was triggered, entities would determine the value that was transferred to the holder when the price adjustment occurred.

Thinking It Through

Under current U.S. GAAP, down-round protection often results in instruments being accounted for as liabilities, with changes in fair value recorded through earnings. Under the proposed changes, fewer instruments are expected to require such classification and resulting fair value treatment. However, many instruments or embedded features are precluded from equity classification because of the existence of other terms (e.g., warrants on contingently redeemable preferred stock) and would therefore be unaffected by this proposed change.

Further, entities that present fair value financial statements (e.g., in accordance with ASC 946) would be largely unaffected by this change.

Removal of the Indefinite Deferral Under ASC 480

The transition guidance in ASC 480-10 indefinitely defers the application of some of its requirements for certain instruments and entities (i.e., certain mandatorily redeemable financial instruments of nonpublic entities that are not SEC registrants and certain mandatorily redeemable noncontrolling interests). Accordingly, such instruments may qualify as equity under U.S. GAAP even though ASC 480-10-25 suggests that they should be classified as liabilities.

ASC 480-10 requires issuers to classify mandatorily redeemable financial instruments as liabilities. Because of the indefinite deferral noted above, these requirements are labeled “pending content” in the Codification, but the transition guidance in ASC 480-10-65 provides no effective date for them. Therefore, the transition requirements under the tentative guidance would effectively provide scope exceptions for parts of the guidance in ASC 480-10 for affected entities and instruments.

Simplifying the Balance Sheet Classification of Debt

Background

The FASB recently directed its staff to draft a proposed ASU that would simplify the classification of debt as either current or noncurrent on the balance sheet. The guidance currently in ASC 470-10 consists of an assortment of fact-specific rules and exceptions, the application of which varies according to the terms and conditions of the debt arrangement, management’s expectations of when debt may be settled or refinanced, and certain post-balance-sheet events. The objective of the project is to reduce the cost and complexity of applying this guidance while maintaining or improving the usefulness of the information provided to financial statement users.

Principles-Based Approach

The FASB’s tentative approach would replace the current, fact-specific guidance with a unified principle for determining the classification of a debt arrangement in a classified balance sheet as either current or noncurrent. Specifically, an entity would classify a debt arrangement as noncurrent if *either* of the following criteria is met as of the financial reporting date:[1]

- “The liability is contractually due to be settled more than 12 months (or operating cycle, if longer) after the balance sheet date.”
- “The entity has a contractual right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after the balance sheet date.”

[1] Quoted text is from the FASB’s summary of tentative Board decisions reached at its January 28, 2015, meeting.

As an exception to this classification principle, debt that is due to be settled within 12 months as a result of a covenant violation as of the balance sheet date would be classified as noncurrent if the debtor receives a waiver that meets certain conditions after the balance sheet date (see Covenant Violations below).

Scope

The FASB has tentatively decided to clarify that the balance sheet classification guidance in ASC 470-10 applies not only to nonconvertible debt arrangements but also to convertible debt and to mandatorily redeemable financial instruments that are classified as liabilities under ASC 480-10.

Short-Term Obligations Expected to Be Refinanced on a Long-Term Basis

Under current guidance, entities that have the intent and ability to refinance a short-term obligation on a long-term basis *after* the financial reporting date — as evidenced by the post-balance-sheet-date issuance of a long-term obligation, equity securities, or a qualifying refinancing agreement — are required to present the obligation as a noncurrent liability as of the financial reporting date. The tentative approach, however, would require such short-term obligations to be classified within current liabilities because the refinancing of debt after the financial reporting date would be viewed as a new transaction that should not be retroactively reflected in the balance sheet as of that date.

Subjective Acceleration Clauses and Debt Covenants

Under existing GAAP, the classification of long-term obligations depends in part on whether they are governed by subjective acceleration clauses (SACs) for which exercise is probable (e.g., because of recurring losses or liquidity problems). Under the Board's tentative approach, however, SACs and covenants within long-term obligations would affect the classification of long-term obligations only when triggered or violated, in which case disclosure of the SAC or covenant would be required.

Thinking It Through

Under the Board's tentative approach, some liabilities that are now classified as noncurrent would be classified as current, and vice versa. For example, as a result of the proposed change to the treatment of the refinancing of short-term obligations, an entity would not be allowed to consider refinancing events after the financial reporting date but before the financial statements were issued. Thus, such debt obligations would be classified as current liabilities as of the financial reporting date. Entities should consider the timing of refinancing plans and the potential effect on the classification of short-term obligations.

Covenant Violations

Under current guidance, if the creditor can demand the repayment of a long-term obligation as of the financial reporting date because of the debtor's violation of a debt covenant, the corresponding debt obligation is classified as noncurrent if the debtor obtains a covenant waiver *before* the date the financial statements are issued and certain other conditions are met. While the Board's tentative approach would retain similar guidance, it would classify such debt as current if the waiver results in the debt's being accounted for as having been extinguished. Because debt extinguishment accounting treats the debt as a newly issued instrument, the original debt obligation, as of the balance sheet date, should be classified within current liabilities since the debtor could demand repayment as of that date.

At its October 19, 2016, meeting, the Board decided to clarify the application of the probability assessment that is associated with the waiver exception. Entities would be required to assess whether a violation of any other covenant not covered by the waiver is probable within 12 months from the reporting date. If so, the related debt would be required to be classified as current.

Presentation and Disclosure

Under the Board's tentative approach, debt that is classified as noncurrent in accordance with the exception for debt covenant waivers would be presented separately in the balance sheet. Further, as previously noted, the tentative approach would require entities to disclose information about debt covenants and SACs upon violation or trigger.

Effective Date and Transition

The Board will determine an effective date for the guidance after it considers feedback on the proposed ASU. Once finalized, the proposed approach will be applicable on a prospective basis to debt that exists as of the effective date. Early adoption will be permitted.

Next Steps

The proposed ASU is expected to be released in December 2016 or early January 2017. The comment period is expected to end no earlier than May 5, 2017.

Goodwill and Business Combinations

Subsequent Accounting for Goodwill for Public Business Entities and Not-for-Profit Entities, Including Goodwill Impairment

Background

In November 2013, the FASB endorsed (and later issued guidance on[2]) a decision by the PCC to give nonpublic business entities an accounting alternative under which they can elect to amortize goodwill and perform a simplified impairment test. The Board received feedback on the PCC accounting alternative indicating that many public business entities and not-for-profit entities had similar concerns about the cost and complexity of the annual goodwill impairment test.

In response, the Board in 2014 added to its agenda a goodwill simplification project that would be completed in two phases. The Board later separated the undertaking into two individual projects: (1) accounting for goodwill impairment and (2) subsequent accounting for goodwill for public business entities and not-for-profit entities.

Current Status and Next Steps

Under ASC 350, impairment of goodwill "is the condition that exists when the carrying amount of goodwill exceeds its implied fair value." The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. The process of measuring the implied fair value of goodwill is currently referred to as step 2 of the goodwill impairment test. Step 2 requires an entity to "assign the fair value of a reporting unit to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business

[2] For more information, see Deloitte's January 27, 2014, *Heads Up*.

combination." Consequently, the performance of step 2 of the goodwill impairment test can result in significant cost and complexity.

As part of its goodwill impairment project, the FASB issued a proposed ASU in May 2016 that would remove step 2 from the goodwill impairment test. The proposed guidance, which is intended to simplify the accounting for goodwill impairment, would require an entity to "recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. However, that amount should not exceed the carrying amount of goodwill allocated to that reporting unit."

The qualitative assessment of goodwill would be unchanged under the proposed ASU. However, all reporting units, even those with a zero or negative carrying amount, would apply the same impairment test. As noted in the proposal's Basis for Conclusions, goodwill of reporting units with a zero or negative carrying amount would not be impaired even when conditions underlying the reporting unit indicate that it was impaired. However, entities would be required to disclose any reporting units with a zero or negative carrying amount and the respective amounts of goodwill allocated to those reporting units.

Thinking It Through

The proposed guidance would significantly change the accounting for goodwill for reporting units with zero or negative carrying amounts. While current guidance addresses the assignment of liabilities to a reporting unit, practitioners have had questions about the assignment of debt. A reporting unit may have a negative carrying amount because of an entity's decision to assign debt to it, resulting in diversity in practice and different goodwill impairment outcomes.

Comments on the proposed ASU were due by July 11, 2016.[3] The FASB is redeliberating the proposed ASU and has not yet determined a proposed effective date for the final standard. A nonpublic business entity that has already elected the PCC's accounting alternative for goodwill and would like to apply the final guidance would need to perform an assessment of preferability in accordance with ASC 250.

As part of its project on the subsequent accounting for goodwill, the Board expects to consider whether to permit or require amortization of goodwill or make further changes to impairment testing methods.

Clarifying the Definition of a Business

Background

In November 2015, the FASB issued a proposed ASU related to the first phase of its project on the definition of a business. The proposal is in response to concerns that the current definition of a business has been interpreted too broadly and that many transactions are accounted for as business combinations when they are more akin to asset acquisitions. Comments on the proposed guidance were due by January 22, 2016, and were analyzed by the FASB staff at its meeting on August 24, 2016. The proposal's key provisions are discussed below. For more information, see Deloitte's December 4, 2015, *Heads Up*.

Under the proposal:

- To be a business, a set of assets and activities ("set") must include an input and a substantive process that together contribute to the ability to create outputs.
- If substantially all the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be a business.
- The definition of outputs is narrowed to be consistent with ASC 606.

[3] See Deloitte's comment letter on the proposed ASU.

Thinking It Through

The proposed guidance may significantly affect the real estate industry as a result of the different accounting for business combinations and asset acquisitions. For example, acquisition costs are expensed in a business combination and capitalized in an asset acquisition. Thus, a more narrow definition of a business will result in more asset acquisitions and, therefore, more capitalized costs.

Single or Similar Asset Concentration

Under the proposal, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be considered a business. Gross assets acquired would exclude cash and cash equivalents, DTAs, and the effects of DTLs. If the fair value of the gross assets cannot be concentrated, the entity would apply the proposed ASU's framework for evaluating whether an input and a substantive process are both present and together contribute to the ability to produce outputs.

In the determination of gross asset concentration, a tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset without incurring significant cost or significant diminution in utility or fair value to either asset (e.g., land and building) would qualify as a single identifiable asset. The FASB also indicated that while tangible and intangible assets should generally not be combined, an in-place lease intangible asset, including any favorable and unfavorable intangible asset or liability, and the related real estate asset would qualify as a single identifiable asset.

Thinking It Through

The introduction of a gross asset concentration threshold is likely to have a significant effect on the real estate industry since many acquisitions of properties with in-place leases that are accounted for as business combinations under current guidance may qualify as asset acquisitions under the proposed guidance.

Input and Substantive Process Requirement

The proposal provides a framework for determining whether a set has an input and a substantive process that collectively contribute to the ability to create outputs. When a set does not yet have outputs, the set would have a substantive process only if it has an organized workforce (or an acquired contract that provides access to an organized workforce) that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to an acquired input or inputs, is critical to the ability to continue producing outputs. For a set with outputs, the FASB proposed less stringent criteria for determining that the set has a substantive process. An organized workforce may represent a substantive process. However, a set may have a substantive process even without an organized workforce if an acquired process or processes contribute to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay or are considered unique or scarce.

Definition of Outputs

Under current guidance (ASC 805-10-55-4), outputs are defined as "[t]he result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." The proposal would change this definition to the "result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest." The revised definition of outputs aligns the definition with the new revenue guidance in ASC 606.

Transition and Effective Date

The amendments in the proposal would be applied prospectively to any transaction that occurs on or after the effective date of the final standard. No disclosures would be required at transition. The FASB will determine the effective date and whether the proposed amendments may be applied before the effective date after it redeliberates its proposal on clarifying the scope of asset derecognition guidance and accounting for partial sales of nonfinancial assets.

Accounting for Identifiable Intangible Assets in a Business Combination

Background

In November 2014, the FASB agreed to add to its agenda a project to explore potential changes to the guidance on accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities. The Board will evaluate whether certain intangible assets should be subsumed into goodwill.

Current Status and Next Steps

The project is in the initial deliberations phase. At the FASB's October 28, 2015, meeting, the Board decided to conduct further research in conjunction with the IASB. The boards discussed the status of their respective projects on this topic at their June 20, 2016, meeting; however, no decisions were made.

Accounting for Derecognition and Partial Sales of Nonfinancial Assets

Background

In June 2016, the FASB issued a proposed ASU that would clarify the scope of the Board's recently established guidance on nonfinancial asset derecognition (ASC 610-20) as well as the accounting for partial sales of nonfinancial assets. The proposed guidance is in response to stakeholder feedback indicating that (1) the meaning of the term "in-substance nonfinancial asset" is unclear because the Board's new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply. The proposed ASU would conform the derecognition guidance on nonfinancial assets with the model for revenue transactions in ASC 606. Comments on the proposed guidance (see Deloitte's comments) were due by August 5, 2016, and the FASB is analyzing the comment letters received.

Key provisions of the proposed ASU are discussed below. For more information, see Deloitte's June 14, 2016, *Heads Up*.

Scope of the Guidance on Nonfinancial Asset Derecognition and Unit of Account

The proposed ASU would clarify the scope of ASC 610-20 and require entities to apply that guidance to the derecognition of all nonfinancial assets and in-substance nonfinancial assets. While the concept of in-substance assets resided in ASC 360-20, this guidance would not have applied to transactions outside of real estate. The FASB is therefore proposing to add to the ASC master glossary the following definition of an in-substance nonfinancial asset:

> An asset of a reporting entity that is included in either of the following:
>
> a. A contract in which substantially all the fair value of the assets (recognized and unrecognized) promised to a counterparty is concentrated in nonfinancial assets
>
> b. A consolidated subsidiary in which substantially all the fair value of the assets (recognized and unrecognized) in the subsidiary is concentrated in nonfinancial assets.
>
> An in substance nonfinancial asset does not include:
>
> a. A group of assets or a subsidiary that is a business or nonprofit activity
>
> b. An investment of a reporting entity that is being accounted for within the scope of Topic 320 on investments — debt securities, Topic 321 on investments — equity securities, Topic 323 on investments — equity method and joint ventures, or Topic 325 on other investments regardless of whether the assets underlying the investment would be considered in substance nonfinancial assets.

Thinking It Through

The proposed ASU's guidance would significantly affect the real estate industry. Under the current guidance, all transfers of real estate (including in-substance real estate and transactions that are considered a business) are accounted for under ASC 360-20. Under the proposed guidance, since business or nonprofit activities are not in-substance nonfinancial assets, they would be excluded from the scope of ASC 610-20 and accounted for under the consolidation guidance in ASC 810-10. Further, all investments would be accounted for under the guidance in ASC 860 on transfers and servicing transactions, regardless of whether the investments were businesses or nonprofit activities or in-substance nonfinancial assets.

Partial Sales

"Partial sales" are sales or transfers of a nonfinancial asset to another entity in exchange for a noncontrolling ownership interest in that entity. Entities account for partial sales before adoption of the new revenue standard principally under the transaction-specific guidance in ASC 360-20 on real estate sales and partly under ASC 845-10-30. Since ASC 606 and ASC 610-20 supersede that guidance, the proposed ASU would clarify that any transfer of a nonfinancial asset in exchange for the noncontrolling ownership interest in another entity (including a noncontrolling ownership interest in a joint venture or other equity method investment) would be accounted for in accordance with ASC 610-20.

In addition, if the reporting entity no longer retained a controlling financial interest in the nonfinancial asset, it would derecognize the asset when it transferred control of that asset in a manner consistent with the principles in ASC 606. Further, any retained noncontrolling ownership interest (and resulting gain or loss to be recognized) would be measured at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-20-32-21 through 32-24.

Thinking It Through

Partial sales are common in the real estate industry (e.g., a seller transfers an asset to a buyer but retains either an interest in the asset or has an interest in the buyer). Under the current real estate guidance in ASC 360-20, entities are required to recognize a partial gain and measure the retained ownership interest in a partial sale of real estate at carryover basis. The proposed ASU would eliminate the differences in the accounting between transactions with assets and businesses and would require an entity that sells real estate assets to recognize full gain when it loses its controlling financial interest and any retained interest in such real estate would be measured at fair value.

Effective Date and Transition

The effective date of the new guidance and the transition methods would be aligned with the requirements in the new revenue standard as amended by ASU 2015-14,[4] which delays the effective date of the new revenue standard by one year and permits early adoption on a limited basis. However, an entity would be permitted to use a transition approach to adopt ASC 610-20 that is different from the one it uses to adopt ASC 606 (e.g., the entity may use the modified retrospective approach to adopt ASC 610-20 and the full retrospective approach to adopt ASC 606). If different methods are used, an entity would need to provide the transition-method disclosures required by ASC 606 and indicate the method it used to adopt ASC 610-20.

Modification Accounting for Share-Based Payment Arrangements

Background

In November 2016, the FASB issued a proposed ASU that would amend the scope of modification accounting for share-based payment arrangements. The proposed ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under ASC 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of the awards are the same immediately before and after the modification.

When ASU 2016-09 was issued in March 2016 under the Board's simplification initiative, it made a change to ASC 718 regarding the exception to liability classification of an award related to an employer's use of a net-settlement feature to withhold shares to meet the employer's statutory tax withholding requirement. Under ASU 2016-09, the net settlement of an award for statutory tax withholding purposes does not result, by itself, in liability classification of the award as long as the amount withheld for taxes does not exceed the *maximum* statutory tax rate in the employee's relevant tax jurisdiction(s). Before an entity adopts ASU 2016-09, the exception applies only when no more than the number of shares necessary for the *minimum* statutory tax withholding requirement to be met is repurchased or withheld.

[4] For public business entities, the standard is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

Upon adopting ASU 2016-09, some entities may change the net-settlement terms of their share-based payment arrangements from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. Some constituents questioned whether this change, if made to existing awards, would require the application of modification accounting under ASC 718-20-35-3. When an entity applies modification accounting to equity-classified awards and the original awards are expected to vest (because of any service or performance conditions) on the modification date, a modification may result in incremental compensation cost.

The proposed ASU's key provisions are discussed below. For more information, see Deloitte's November 18, 2016, *Heads Up*.

Key Provisions of the Proposed ASU

Scope of Modification Accounting

The proposed ASU would amend ASC 718 to limit the instances in which modification accounting is applied. Entities "would account for the effects of a modification unless all the following are the same immediately before and after the modification":

- "The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the award."
- "The vesting conditions of the award."
- "The classification of the award as an equity instrument or a liability instrument."

In addition, as a consequential amendment, the proposal would remove the phrase "any of" from the definition of "modification." Under the proposed ASU, a modification would be defined as a "change in the terms or conditions of a share-based payment award."

The proposal's Basis for Conclusions provides additional clarity on the application of proposed ASC 718-20-35-2A(a), which requires that the fair value be the same immediately before and after the modification for modification accounting not to be applied. In paragraph BC11, the Board clarified that the evaluation should be based on whether the fair value has changed, not on whether the compensation cost recognized has changed. In addition, BC14 clarifies that a computation of the fair value before and after the modification is not expected in all cases. Rather, if the entity determines that the modification does not affect any of the inputs used in its fair value calculation, the entity most likely could conclude that the fair value would be the same immediately before and after the modification.

The proposed ASU's Basis for Conclusions also provides examples (that "are educational in nature, are not all-inclusive, and should not be used to override the guidance in paragraph 718-20-35-2A") of changes to awards for which the Board believes that modification accounting would not be required as well as those for which the Board believes that it would be required. The following table summarizes those examples:

Examples of Changes for Which Modification Accounting Would Not Be Required	Examples of Changes for Which Modification Accounting Would Be Required
• Administrative changes, such as a change to the company name, company address, or plan name. • Changes in net-settlement provisions related to tax withholdings that do not affect the classification of the award.	• Repricing of options that results in a change in value. • Changes in a service condition. • Changes in a performance condition or a market condition. • Changes in an award that results in a reclassification of the award (equity to liability or vice versa). • The addition of a change-in-control provision under which awards are immediately vested upon occurrence of the event.

Disclosures

ASC 718 currently requires entities to disclose a description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications. Under the proposed ASU, additional disclosures would not be required.

Thinking It Through

Entities would still be required to disclose any significant changes to the terms or conditions of share-based payment awards that meet the definition of a modification under ASC 718-20-20, even if modification accounting is not applied under the proposed ASU. For example, under the proposed ASU, if an entity changes the settlement terms of its share-based payment awards but such a change does not result in a change in fair value, vesting condition, or classification, modification accounting would not be applied. However, the entity may still be required to disclose the change in settlement terms if the modification is significant.

Effective Date and Transition

The FASB plans to determine an effective date for the final guidance after considering stakeholder feedback on the proposed ASU. Entities would apply the proposed amendments prospectively to modifications on or after the effective date, and transition disclosures would not be required.

Nonemployee Share-Based Payment Accounting Improvements

Background

In December 2015, the FASB decided to add to its agenda a project on improving the accounting for nonemployee share-based payment arrangements. When the Board previously deliberated its initial share-based payment simplification project, it decided that potential improvements to the nonemployee model could involve broader changes and take longer to complete than other simplification projects. As a result, the Board concluded that reconsideration of the accounting for nonemployee share-based payments should be moved to a separate project.

Tentative Decisions

In May 2016, the FASB tentatively decided to expand the scope of ASC 718 to include all share-based payment arrangements related to acquiring both goods and services from nonemployees. The Board's tentative decision would require an entity to apply most of the guidance in ASC 718 to nonemployee share-based payments. In addition, a nonpublic entity would be permitted to use certain practical expedients, including the use of (1) calculated value to measure certain nonemployee awards and (2) intrinsic value to measure liability-classified nonemployee awards. Further, nonemployee share-based payments initially within the scope of ASC 718 would remain within the scope of that guidance for classification and measurement purposes (even after the nonemployee awards have vested) unless the awards are modified after performance is complete.

However, the FASB tentatively decided that attribution of any cost associated with nonemployee share-based payments would continue to be accounted for under other applicable accounting literature as though the issuer had paid cash for the goods or services.

Thinking It Through

Nonemployee share-based payments issued for goods and services are accounted for under ASC 505-50. The guidance in ASC 505-50 differs significantly from ASC 718, including the (1) determination of the measurement date, (2) accounting for performance conditions, (3) ability to use nonpublic entity practical expedients, and (4) classification of awards after vesting. The tentative decisions of this project would align such guidance.

Transition

The Board tentatively decided that a modified retrospective transition approach, with a cumulative-effect adjustment to retained earnings, would generally be required for outstanding nonemployee awards at the time of adoption. However, in allowing nonpublic companies to use calculated values to measure certain nonemployee awards, the Board tentatively decided that a prospective approach should be used for all nonemployee awards that are measured at fair value after the date of adoption.

Disclosures

With the exception of disclosures specifying the income statement effects of the change in principle in the year of adoption (or interim periods therein), the Board tentatively decided that an entity should apply the disclosure requirements in ASC 250 related to a change in accounting principle.

Finally, the Board tentatively decided that the disclosure requirements for nonemployee awards should be aligned with those in ASC 718 and that these requirements did not need to be modified.

Next Steps

At its November 30, 2016, board meeting, the FASB directed its staff to draft a proposed ASU with a 90-day comment period. The staff indicated that it expects to issue the proposal in the first quarter of 2017.

Disclosures by Business Entities About Government Assistance

Background and Key Provisions of the Proposed Guidance

In November 2015, the FASB issued for public comment a proposed ASU to increase transparency in financial reporting by requiring specific disclosures about government assistance received by businesses. Government assistance arrangements are legally enforceable agreements under which the government provides value to the entity (e.g., grants, loan guarantees, tax incentives). The objective of the proposed disclosure requirements is to enable financial statement users to better assess (1) the nature of the government assistance, (2) the accounting policies for the government assistance, (3) the impact of the government assistance on the financial statements, and (4) the significant terms and conditions of the government assistance arrangements.

There is no explicit guidance in current U.S. GAAP on the recognition, measurement, and disclosure of government assistance received by business entities. As a result, there is diversity in practice related to how business entities account for, and disclose information about, government assistance arrangements.

The proposed ASU would require business entities to disclose the following information about government assistance arrangements in their annual financial statements:

1. Information about the nature of the assistance, including a general description of the significant categories and the related accounting policies adopted or the method applied to account for government assistance
2. Which line items on the balance sheet and income statement are affected by government assistance and the amounts applicable to each line item
3. Significant terms and conditions of the agreement, including commitments and contingencies
4. Unless impracticable, the amount of government assistance received but not recognized directly in the financial statements. The amount of government assistance received but not recognized includes value that was received by an entity for which no amount has been recorded directly in any financial statement line item (for example, a benefit of a loan guarantee, a benefit of a below-market rate loan, or a benefit from tax or other expenses that have been abated).

Such disclosures would provide financial statement users with information about the effect of government assistance on an entity's financial results and prospects for future cash flows. In addition, the disclosures would help users better assess the nature of the assistance.

The proposed amendments would apply to entities (other than not-for-profit entities within the scope of ASC 958, employee benefit plans, and entities that have entered into government assistance agreements within the scope of ASC 740) that have entered into a "legally enforceable agreement with a government to receive value." However, such provisions would not apply to transactions in which the government is (1) "legally required to provide a nondiscretionary level of assistance to an entity simply because the entity meets applicable eligibility requirements that are broadly available without specific agreement between the entity and the government" or (2) "solely a customer" of the entity.

Effective Date and Transition

The FASB plans to determine an effective date for the final guidance after considering stakeholder feedback on the proposed ASU. To apply the guidance, entities would use a prospective approach; however, retrospective application would be allowed.

Redeliberations and Next Steps

Since the conclusion of the comment letter period on February 10, 2016, the FASB has held redeliberation sessions to discuss comments received from constituents. The tentative decisions reached as a result of the Board's redeliberations at its meeting on June 8, 2016, are reflected above.

The Board will continue to conduct additional redeliberations at future meetings before issuing a final ASU.

Disclosure Framework

Background

In July 2012, the FASB issued a discussion paper as part of its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. The FASB subsequently decided to distinguish between the "FASB's decision process" and the "entity's decision process" for evaluating disclosure requirements.

FASB's Decision Process

Overview

In March 2014, the FASB released for public comment a proposed concepts statement that would add a new chapter to the Board's conceptual framework for financial reporting. The proposal outlines a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FABS's objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte's March 6, 2014, *Heads Up* for additional information.

In February 2015, the Board tentatively decided that the disclosure section of each Codification subtopic (1) would state that an entity should apply materiality as described in the proposed amendments to ASC 235 in complying with the disclosure requirements and (2) would not contain language that precludes an entity from exercising discretion in determining what disclosures are necessary (e.g., "shall at a minimum provide").

In September 2015, in response to feedback from outreach activities and to maintain consistency with both current practice and the FASB's proposed ASU on the omission of immaterial disclosures (see Entity's Decision Process below for discussion of the proposed ASU), the Board issued a proposal to modify the definition of materiality in Concepts Statement 8. The proposal would replace the original discussion of materiality in Concepts Statement 8 with the U.S. Supreme Court's definition. See Deloitte's September 28, 2015, *Heads Up* for additional information.

Comments on the proposed changes to Concepts Statement 8 have been provided to the FASB.

Entity's Decision Process

In September 2015, to reduce entities' reluctance to omit immaterial disclosures, the FASB issued a proposed ASU that would amend the Codification to indicate that the omission of disclosures about immaterial information is not an accounting error. The proposal, which is part of the FASB's disclosure effectiveness initiative, notes that materiality is a legal concept applied to assess quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole. See Deloitte's September 28, 2015, *Heads Up* for additional information.

Comments on the proposed ASU have been provided to the FASB.

Next Steps

The FASB will continue deliberating concerns raised in comment letters and will review feedback received as a result of its outreach activities, which include testing the Board's and entity's decision processes against various Codification topics. A final concepts statement is expected to be issued after the outreach process is complete.

Topic-Specific Disclosure Reviews

In addition to proposing amendments to guidance, the FASB is analyzing ways to "further promote [entities'] appropriate use of discretion"[5] in determining proper financial statement disclosures. The Board is applying the concepts in both the entity's and the Board's decision process in considering topic-specific modifications. The FASB reached tentative decisions about disclosure requirements in the following Codification topics:

- ASC 820 (fair value measurement).
- ASC 740 (income taxes).
- ASC 715-20 (defined benefit plans).

Proposed changes to the disclosure requirements are discussed below.

[5] Quoted from "What You Need to Know About Disclosure Framework" on the FASB's Web site.

Fair Value Measurement

Objective for Disclosures

In December 2015, the FASB issued for public comment a proposed ASU that would amend the requirements in ASC 820 for disclosing fair value measurements. The proposed ASU would add the following objective to ASC 820 to encourage preparers to use discretion in complying with the disclosure requirements:

> The objective of the disclosure requirements in this Subtopic is to provide users of financial statements with information about all of the following:
>
> a. The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
>
> b. The effects of changes in fair value on the amounts reported in financial statements
>
> c. The uncertainty in the fair value measurement of Level 3 assets and liabilities as of the reporting date
>
> d. How fair value measurements change from period to period.

In addition, the proposed ASU would make changes (eliminations, modifications, and additions) to the fair value disclosure requirements in ASC 820, as discussed below.

Eliminated and Modified Disclosure Requirements

Policy on Timing of Transfers Between Levels and Transfers Between Levels 1 and 2

The proposed ASU would remove the requirement in ASC 820-10-50-2C for an entity to disclose its policy on the timing of transfers between levels of the fair value hierarchy. An entity would still be required to have a consistent policy on timing of such transfers. The requirement to separately disclose the amounts transferred between Level 1 and Level 2 and the corresponding reason for doing so would also be removed.

Level 3 Fair Value Measurements

The disclosure requirements for Level 3 fair value measurements would be amended as follows:

- *Valuation process* — The proposed ASU would remove requirements in ASC 820-10-50-2(f) (and related implementation guidance in ASC 820-10-55-105) for an entity to disclose its valuation processes for Level 3 fair value measurements.

Thinking It Through

Removing the disclosure requirement in ASC 820-10-50-2(f) will result in divergence between U.S. GAAP and IFRSs. The requirement was added to the FASB's and IASB's jointly issued standard on the basis of a recommendation by the IASB's expert panel. The panel explained that the disclosure would help users understand the quality of the entity's fair value estimates and give investors more confidence in management's estimate. The FASB has proposed to remove the requirement because it would conflict with the Board's proposed concepts statement. The Board indicated that disclosure of internal control procedures is outside the purpose of the notes to the financial statements and is not required under other topics in U.S. GAAP.

Removing this requirement does not change management's responsibility for internal controls over the valuation process and related auditor testing. Further, it should not affect investor confidence in the quality of the fair value estimate given the regulatory environment in the United States (e.g., SEC and PCAOB) as well as the intense scrutiny in this area. The Board also noted that investors are typically familiar with the overall valuation process.

- *Measurement uncertainty* — The proposed ASU would retain the requirement in ASC 820-10-50-2(g) to provide a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. However, it would clarify that this disclosure is intended to communicate information about the uncertainty in measurement as of the reporting date and not to provide information about sensitivity to future changes in fair value.
- *Quantitative information about unobservable inputs* — The proposed ASU would require disclosure of the range and weighted average of the unobservable inputs to comply with the requirement in ASC 820-10-50-2(bbb) (as shown by example in the implementation guidance in ASC 820-10-55-103). Disclosing the period used to develop significant unobservable inputs based on historical data would also be required. A private company would be exempt from such a disclosure requirement.
- *Level 3 rollforward* — The proposed ASU would retain the Level 3 rollforward requirement for entities that are not private companies. For entities that are private companies, the proposed ASU would modify the Level 3 rollforward requirement and remove the requirement to disclose the change in unrealized appreciation or deprecation related to investments held as of the balance sheet date under ASC 820-10-50-2(d). Instead, disclosures would be required about transfers into and out of Level 3 and purchases (and issues) of Level 3 investments. The Board indicated that entities are already required to disclose the ending balance in the fair value hierarchy table, and they could disclose transfers into (and out of) and purchases (or issues) of Level 3 investments in a sentence rather than in a full rollforward as required today. A defined benefit plan sponsor that is a private company would also remove the reconciliation of beginning and ending balances for plan investments categorized as Level 3 within the fair value hierarchy (i.e., the Level 3 rollforward) and would be required to disclose transfers into and out of Level 3 and purchases (or issues) of Level 3 assets only in its defined benefit plan footnote (for more information about the FASB's project on reviewing defined benefit plan disclosures, see discussion below).

Thinking It Through

In its outreach on the Level 3 rollforward, the Board noted that some financial statement users believe that the rollforward is useful because it helps them understand management's decisions, especially for different economic cycles. The full rollforward was generally deemed less useful for users of private-company financial statements. Transfers into and out of Level 3 were generally considered to be the most useful aspect of the rollforward.

Net Asset Value Disclosures of Estimates of Timing of Future Events

The following disclosures currently required under ASC 820-10-50-6A(b) and ASC 820-10-50-6A(e) would apply only when they have been communicated to the reporting entity by the investee or are otherwise made publicly available (even if not specifically communicated to the investor):

- "For each class of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity's estimate of the period of time over which the underlying assets are expected to be liquidated by the investees."
- "[W]hen the restriction from redemption might lapse."

If the timing is unknown, the entity would be required to disclose that fact.

Thinking It Through

The objective of this change is to prevent an investor from having to make its own estimate when it does not have knowledge of the timing from the investee or other public source. In addition, ASU 2015-07 removed the requirement for entities to categorize within the levels of the fair value hierarchy all investments they have measured under the net asset value practical expedient.

New Disclosure Requirements — Unrealized Gains and Losses

Entities that are not private companies would disclose fair value changes for assets and liabilities held as of the balance sheet date disaggregated by fair value hierarchy level (i.e., Levels 1, 2, and 3) for (1) net income before taxes and (2) comprehensive income. This is currently required only for the Level 3 amounts within net income under ASC 820-10-50-2(c) and (d). This requirement would not apply to private companies in accordance with the private-company decision-making framework.

Transition and Next Steps

The proposed ASU requires that the modifications to disclosures about changes in unrealized gains and losses and the changes in the quantitative information about unobservable inputs (see discussion above) would be applied prospectively beginning in the period of adoption. Entities would apply all other changes in disclosures retrospectively to all periods presented.

The FASB did not propose an effective date. Rather, the Board indicated that it plans to determine such date after considering stakeholders' feedback on the proposed guidance.

Comments on the proposed ASU were due by February 29, 2016, and were discussed at the FASB's meeting on June 1, 2016, at which it was decided that additional outreach would be conducted with investors and other financial statement users. It is not currently expected that a final ASU will be issued in 2016.

Income Taxes

Background

In July 2016, the FASB issued a proposed ASU that would modify or eliminate certain disclosure requirements related to income taxes as well as establish new requirements. The proposed ASU is the result of the application of the Board's March 2014 proposed concepts statement to disclosures about income taxes. Comments on the proposed ASU were due by September 30, 2016.

Key Provisions of the Proposed ASU

Scope

Although many of the amendments would apply to all entities that are subject to income taxes, certain amendments would apply only to public business entities.

As part of the proposal, the FASB decided that it would also replace the term "public entity," as defined in the glossary in ASC 740-10, with "public business entity," as defined in the ASC master glossary. The definition of a public business entity includes certain types of entities that the definition of a public entity under ASC 740 does not include. Thus, the disclosure requirements in ASC 740 that currently apply only to public entities would apply to other entities as well.

Indefinitely Reinvested Foreign Earnings

The proposed ASU would require all entities to explain any change to an indefinite reinvestment assertion made during the year, including the circumstances that caused such change in assertion. All entities would also be required to disclose the amount of earnings for which there was a change in assertion made during the year. In addition, all entities would be required to disclose the aggregate of cash, cash equivalents, and marketable securities held by their foreign subsidiaries.

Such information is intended to give financial statement users information that will help them predict the likelihood of future repatriations and the associated income tax consequences related to foreign indefinitely reinvested earnings.

Unrecognized Tax Benefits

The proposed ASU would modify the disclosure requirements for a public business entity related to unrecognized tax benefits. It would also add a requirement for entities to disclose, in the tabular reconciliation of the total amount of unrecognized tax benefits required by ASC 740-10-50-15A(a), settlements disaggregated by those that have been (or will be) settled in cash and those that have been (or will be) settled by using existing DTAs (e.g., settlement by using existing net operating loss or tax credit carryforwards).

A public business entity would also be required to provide a breakdown (i.e., a mapping) of the amount of total unrecognized tax benefits shown in the tabular reconciliation by the respective balance-sheet lines on which such unrecognized tax benefits are recorded. If an unrecognized tax benefit is not included in a balance-sheet line, such amount would be disclosed separately. In addition, a public business entity would be required to disclose the total amount of unrecognized tax benefits that are offset against existing DTAs for net operating loss and tax credit carryforwards.

Under the guidance currently in ASC 740-10-50-15(d), all entities must disclose details of tax positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months. The proposed ASU would eliminate this disclosure requirement.

Further, the proposed ASU would amend the example in ASC 740-10-55-217 to illustrate the applicability of the proposed disclosure requirements related to unrecognized tax benefits.

Operating Loss and Tax Credit Carryforwards

Currently, entities are required to disclose the amount and expiration dates of operating losses and tax credit carryforwards for tax purposes. Historically, there has been diversity in practice related to this disclosure requirement. The proposed ASU would reduce this diversity by requiring a public business entity to disclose the total amount of:

- Federal, state, and foreign gross net operating loss and tax credit carryforwards (i.e., not tax effected) by period of expiration for each of the first five years after the reporting date and a total for any remaining years.
- Federal, state, and foreign DTAs related to net operating loss and tax credit carryforwards (i.e., tax effected) before any valuation allowance.

Thinking It Through

Generally, an entity should measure a DTA in accordance with the recognition and measurement criteria in ASC 740. While the proposed ASU uses the term "deferred tax asset," it is unclear whether that term as used in the proposal refers to a DTA measured under the ASC 740 criteria or simply the tax-effected amount of the net operating loss and tax credit carryforwards as reflected on the income tax returns as filed.

As discussed previously, a public business entity would also be required to disclose the total amount of unrecognized tax benefits that are offset against existing DTAs for net operating loss and tax credit carryforwards.

In addition, the proposed ASU would modify the disclosure requirement related to net operating loss and tax credit carryforwards for entities other than public business entities. An entity other than a public business entity would be required to disclose the total gross amounts of federal, state, and foreign net operating loss and tax credit carryforwards (i.e., not tax effected) along with their expiration dates. The example in ASC 740-10-55-218 through 55-222 (as amended) would illustrate the applicability of these disclosure requirements.

Rate Reconciliation

ASC 740-10-50-12 currently requires a public business entity to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the domestic federal statutory tax rate. The proposed ASU would amend the requirement for a public business entity to disclose the income tax rate reconciliation in a manner consistent with SEC Regulation S-X, Rule 4-08(h).

As amended, ASC 740-10-50-12 would continue to require a public business entity to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the domestic federal statutory tax rate. However, the amendment would modify the requirement to disaggregate and separately present components in the rate reconciliation that are greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with the requirement in Rule 4-08(h).

Government Assistance

As a result of deliberations on its November 2015 proposed ASU on government assistance, the FASB decided to require an entity to disclose certain information related to assistance received from a governmental unit that reduces the entity's income taxes. Accordingly, the proposed ASU on income tax disclosures would require all entities that receive income tax-related government assistance to disclose a "description of a legally enforceable agreement with a government, including the duration of the agreement and the commitments made with the government under that agreement and the amount of benefit that reduces, or may reduce, its income tax burden." This disclosure requirement would apply only when the government determined whether, under such agreement, the entity would receive assistance and, if so, how much it would receive even if it met the applicable eligibility requirements. In the absence of a specific agreement between the entity and the government, the entity would not be required to disclose this information if the entity obtained the government assistance because it met eligibility requirements that apply to all taxpayers.

Other Income Tax Disclosure Requirements

The proposed ASU would require all entities to disclose the following:

- The amount of pretax income (or loss) from continuing operations disaggregated by foreign and domestic amounts.
- The amount of income tax expense (or benefit) from continuing operations disaggregated by foreign and domestic amounts.
- The amount of income taxes paid disaggregated by foreign and domestic amounts. A further disaggregation would be required for any country that is significant to the total amount of income taxes paid.
- An enacted tax law change if it is probable that such change would have an effect on the entity in the future.

In the determination of pretax income (or loss), foreign income tax expense (or benefit), or foreign income taxes paid, "foreign" refers to any country outside the reporting entity's home country.

In addition, the proposal would require public business entities to explain any valuation allowance recognized or released during the year along with the corresponding amount.

The proposed ASU is also aligned with the guidance in the proposed ASU on assessing the materiality of disclosures, which allows an entity to consider materiality when assessing income tax disclosure requirements.

Transition Guidance and Effective Date

The proposed ASU's amendments would be applied prospectively. The FASB will determine an effective date for the final guidance after it has considered feedback from stakeholders.

Defined Benefit Plans

In January 2016, the FASB issued a proposed ASU that would modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The proposed ASU contains an overall objective for the disclosures and guidance on how an entity would consider materiality in determining the extent of its defined benefit plan disclosures. The proposed ASU would add to or remove from ASC 715 a number of disclosure requirements related to an entity's defined benefit pension and other postretirement plans. The Board believes that additional costs incurred by entities as a result of implementing the proposed new disclosure requirements would be offset by cost reductions associated with the elimination of other disclosure requirements as well as the omission of immaterial disclosures.

The amendments in the proposed ASU would be applied retrospectively to all periods presented, except for those related to disclosures about plan assets that entities measure by using the net asset value practical expedient. Such changes would be applied beginning with the initial period of adoption.

The FASB received more than 30 comment letters (which were due by April 25, 2016) on the proposal from various respondents, including preparers, professional and trade organizations, and accounting firms. At its meeting on July 13, 2016, the FASB discussed a summary of the comments received and directed its staff to perform research on particular aspects of the proposed ASU. For additional information about the proposed ASU, see Deloitte's January 28, 2016, *Heads Up*.

Other Topics

SEC and AICPA Updates

Background

The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act and to implement provisions under the FAST Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

Non-GAAP Measures

Press coverage and SEC scrutiny of non-GAAP measures have resulted from the SEC's concerns about (1) the increased use and prominence of such measures, (2) their potential to be misleading, and (3) the progressively larger difference between the amounts reported for them and for GAAP measures. In a speech on June 27, 2016, SEC Chair Mary Jo White reiterated the SEC's concerns about practices that can result in misleading non-GAAP disclosures. She exhorted companies "to carefully consider [SEC guidance on this topic] and revisit their approach to non-GAAP disclosures." She also urged "that appropriate controls be considered and that audit committees carefully oversee their company's use of non-GAAP measures and disclosures."

In May 2016, the SEC staff issued new and updated Compliance and Disclosure Interpretations (C&DIs) that clarify the SEC's guidance on non-GAAP measures. The updated guidance was intended to change certain practices about which the SEC has expressed concern. In remarks after the issuance of the C&DIs, the SEC staff strongly encouraged registrants to "self-correct" before the staff considers any further rulemaking or enforcement action related to non-GAAP measures.

For more information, see Deloitte's *A Roadmap to Non-GAAP Financial Measures*.

Thinking It Through

For the 12 months ended July 31, 2016, non-GAAP measures ranked second in the top-ten list of topics frequently commented on by the SEC's Division of Corporation Finance (the "Division") as part of its filing review process, moving up from fourth place for the comparable prior year. Over the next year, we expect the number of SEC comments to continue to remain high and even increase until the guidance in the updated C&DIs has been fully incorporated into practice. The SEC staff's most recent comment letters have particularly focused on the use and prominence of non-GAAP measures in press releases. Comments on press releases and filed documents have also centered on disclosures, including reconciliation requirements and the purpose and use of such measures. In addition, we expect to see more comments about the use of misleading measures, including measures that use individually tailored accounting principles, and the tax effect of non-GAAP adjustments. For more information about SEC comment letter trends, see Deloitte's *SEC Comment Letters — Including Industry Insights: What "Edgar" Told Us* and the 2016 supplement, *SEC Comment Letters — Statistics According to "Edgar."*

SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing

In October 2016, the SEC voted to adopt changes to modernize and enhance the reporting and disclosure of information by registered investment companies and to enhance liquidity risk management by open-end funds, including mutual funds and exchange traded funds. The new rules will enhance the quality of information available to investors and will allow the SEC to more effectively collect and use data reported by funds. The rules will also promote effective liquidity risk management across the open-end-fund industry and will enhance disclosure regarding fund liquidity and redemption practices. The new rules permit the use of "swing pricing" by certain open-end management investment companies.

The changes are part of the Commission's initiative to enhance its monitoring and regulation of the asset management industry.

For more information, see the press release on the SEC's Web site.

SEC Issues Rules for Securities Clearing Agencies

In September 2016, the SEC issued a final rule and a proposed rule related to covered clearing agencies.

The final rule establishes "enhanced standards for the operation and governance" of covered clearing agencies. The final rule's scope includes "SEC-registered securities clearing agencies that have been designated as systemically important by the Financial Stability Oversight Council . . . or that are involved in more complex transactions." Such clearing agencies "will be subject to new requirements regarding, among other things, their financial risk management, governance, recovery planning, operations, and disclosures to market participants and the public."

Under the proposed rule, a covered clearing agency would be defined as "any registered clearing agency that provides the services of a central counterparty, central securities depository, or a securities settlement system." The proposal would also define various terms related to covered clearing agencies.

For more information, see the press release on the SEC's Web site.

SEC Reminds Registrants of Best Practices for Implementing New Revenue, Lease, and Credit Loss Accounting Standards

In recent speeches, the SEC staff has reminded registrants about best practices to follow in the periods leading up to the adoption of ASU 2014-09 (on revenue), ASU 2016-02 (on leases), and ASU 2016-13 (on credit losses). The staff's comments, which reiterated themes the Commission has addressed over the past year, focused on internal control over financial reporting (ICFR), auditor independence, and disclosures related to implementation activities.

For more information, see Deloitte's September 22, 2016, *Financial Reporting Alert*.

SEC Proposes to Shorten Standard Settlement Cycle for Broker-Dealer Securities Transactions

In September 2016, the SEC issued a proposed rule that would "shorten the standard settlement cycle for most broker-dealer transactions from three business days after the trade date ('T+3') to two business days after the trade date ('T+2')." The purpose of the proposed amendments is "to reduce a number of risks, including credit risk, market risk, and liquidity risk and, as a result, reduce systemic risk for U.S. market participants."

For more information, see the press release on the SEC's Web site.

SEC Publishes Final Rule on Cross-Border Security-Based Swaps

In February 2016, the SEC issued a final rule related to cross-border security-based swaps (SBSs). Under the final rule, which is being issued in response to a mandate of the Dodd-Frank Act, "a non-U.S. company that uses personnel located in a U.S. branch or office to arrange, negotiate, or execute a security-based swap transaction in connection with its dealing activity [must] include that transaction in determining whether it is required to register as a security-based swap dealer."

For more information, see the press release on the SEC's Web site.

SEC Publishes Final Rules on SBSs

In April 2016, the SEC issued final rules on SBSs that "implement provisions of Title VII relating to business conduct standards and the designation of a chief compliance officer for [SBS] dealers and major [SBS] participants." In addition, the rules address "the cross-border application of the rules and the availability of substituted compliance." The final rules, which became effective on July 12, 2016, include:

- *Rule 15Fh-1* — Defines the scope of the rules.
- *Rule 15Fh-2* — Defines terms used throughout the rules.
- *Rule 15Fh-3* — Addresses the business conduct requirements applicable to SBS entities.
- *Rule 15Fh-4* — Outlines unlawful activities for SBS entities and contains requirements for SBS dealers that advise special entities.
- *Rule 15Fh-5* — Provides requirements for SBS entities that act as counterparties to special entities.
- *Rule 15Fh-6* — Imposes pay-to-play restrictions on SBS dealers.
- *Rule 15k-1* — Outlines requirements for chief compliance officers.

For more information, see the speech by SEC Chair Mary Jo White on the SEC's Web site.

SEC Issues Final Rule to Establish Trade Acknowledgment and Verification Requirements for SBS Transactions

In June 2016, the SEC issued a final rule to establish trade acknowledgment and verification requirements for SBS transactions. Under the final rule, which is being issued in response to a mandate of the Dodd-Frank Act, an SBS entity that enters into an SBS transaction is required to do the following:

- "Provide a trade acknowledgment electronically to its transaction counterparty promptly, and no later than the end of the first business day following the day of execution."
- "Promptly verify or dispute with its counterparty the terms of a trade acknowledgment it receives."
- "Have written policies and procedures in place that are reasonably designed to obtain verification of the terms outlined in any trade acknowledgment that it provides."

In addition, certain broker-dealers that are SBS entities will be exempt from the requirements in Exchange Act Rule 10b-10 if they meet the requirements of the final rule. The final rule became effective on August 16, 2016.

For more information, the press release on the SEC's Web site.

SEC Issues Final Rule on Regulation SBSR

In July 2016, the SEC issued a final rule that amends Regulation SBSR on the reporting and dissemination of SBS information. The purpose of the final rule, which implements requirements in Title VII of the Dodd-Frank Act, is to "increase transparency in the security-based swap market." The final rule became effective on October 11, 2016.

For more information, see the press release on the SEC's Web site.

SEC Issues Final Rule Granting Regulatory Access to Data Held by SBS Data Repositories

In August 2016, the SEC issued a final rule that amends Rule 13n-4 of the Exchange Act to give certain regulators and other authorities access to SBS data repositories. Specifically, the final rule:

- Requires "either a memorandum of understanding or other arrangement between the Commission and the recipient of the data to address the confidentiality of the security-based swap data provided to the recipient."
- Identifies "the five prudential regulators named in the statute, as well as the Federal Reserve banks and the Office of Financial Research, as being eligible to access data."
- Addresses "factors that the Commission may consider in determining whether to permit other entities to access data."

For more information, see the press release on the SEC's Web site.

SEC Issues Proposed and Final Rules Related to Investment Advisers

In June 2016, the SEC issued a proposed rule that would require "SEC-registered investment advisers to adopt and implement written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations." Further, such advisers would need to "make and keep all business continuity and transition plans that are currently in effect or at any time within the past five years were in effect."

In August 2016, the SEC issued a final rule (effective October 31, 2016) to improve the reporting and disclosure requirements for investment advisers. Specifically, the final rule amends:

- Form ADV to (1) require investment advisers to disclose additional information (e.g., about their "separately managed account business"), (2) include an approach under which "private fund adviser entities operating a single advisory business" can use a single Form ADV to register, and (3) make certain technical corrections to "Form ADV items and instructions."
- Investment Advisers Act rules to (1) require advisers to maintain additional records of performance-related calculations and communications and (2) "remove transition provisions that are no longer necessary."

Advisers will need to begin complying with the amendments on October 1, 2017.

For more information on the proposed rule, see the press release on the SEC's Web site.

For more information on the final rule, see the press release on the SEC's Web site.

SEC Requests Comments on Regulation S-K

In April 2016, the SEC issued a concept release that seeks feedback from constituents on modernizing certain business and financial disclosure requirements of Regulation S-K. The main requirements of Regulation S-K, which is the central repository for nonfinancial statement disclosure requirements for public companies, were established more than 30 years ago, and the modernization and optimization of these requirements may be called for as a result of evolving business models, new technology, and changing investor interests.

The release is part of the SEC's ongoing disclosure effectiveness initiative, which is a broad-based review of the Commission's disclosure, presentation, and delivery requirements for public companies. It follows the SEC's issuance last fall of a request for comment that sought feedback on the effectiveness of financial disclosure requirements in Regulation S-X that apply to certain entities other than the registrant.

For more information, see Deloitte's April 18, 2016, *Heads Up*.

SEC Requests Comments on Certain Regulation S-K Disclosure Requirements

In August 2016, the SEC published a request for comment (with an October 31, 2016, comment deadline) as part of its disclosure effectiveness initiative. The request for comment seeks feedback on certain disclosure requirements in Subpart 400 of Regulation S-K related to management, certain security holders, and corporate governance matters. The Commission plans to take the comments received into account when it develops its study on Regulation S-K, which is required by the FAST Act.

For more information, see the press release on the SEC's Web site.

SEC Proposes to Eliminate Outdated and Duplicative Disclosure Requirements

In July 2016, the SEC issued a proposed rule that would amend certain of the Commission's disclosure requirements that may be redundant, duplicative, or outdated, or may overlap with other SEC, U.S. GAAP, or IFRS disclosure requirements. The proposal also seeks comment on whether certain of the SEC's disclosure requirements that overlap with requirements under U.S. GAAP should be retained, modified, eliminated, or referred to the FASB for potential incorporation into U.S. GAAP.

The proposed amendments are the next step in the SEC's ongoing disclosure effectiveness initiative. As part of the initiative, the SEC in April 2016 also issued a concept release that sought feedback on modernizing certain business and financial disclosure requirements of Regulation S-K.

Thinking It Through

The implications of the proposal are likely to vary depending on the category of change (e.g., duplicate, overlapping, superseded). The effect of some changes may not be significant if their purpose is only to eliminate a duplicated or superseded requirement. Changes to address overlapping requirements could have a more significant effect since they can result in what the SEC describes as (1) disclosure location considerations and (2) bright-line threshold considerations.

For more information, see Deloitte's July 18, 2016, *Heads Up* and the press release on the SEC's Web site.

SEC Staff Updates C&DIs Related to Regulation S-K, the Securities Act, and Other Topics

In October 2016, the Division updated C&DIs related to Regulation S-K, Item 402(u), and added the following new questions:

- *Question 128C.01* — Clarifies what type of consistently applied compensation measure (CACM) a registrant should select to identify the median employee when a registrant does not use annual total compensation calculated in accordance with Regulation S-K, Item 402(c)(2)(x).
- *Question 128C.02* — Clarifies whether a registrant may use hourly or annual rates of pay in determining its CACM.
- *Question 128C.03* — Clarifies the time period a registrant may use when it uses a CACM to identify the median employee.

- *Question 128C.04* — Clarifies the treatment of furloughed employees by registrants in the identification of the median employee.
- *Question 128C.05* — Clarifies the circumstances under which a worker is considered an independent contractor or a leased worker.

In September 2016, the Division issued the following C&DIs:

- *Question 139.33 and Question 126.41 related to Securities Act sections and forms* — Include guidance on self-directed "brokerage windows."
- *Question 301.03 related to Regulation AB* — Clarifies whether a funding-agreement-backed note with certain characteristics should be considered an "asset-backed security," as that term is defined in either Item 1101(c) of Regulation AB or Section 3(a)(79) of the Exchange Act.

In July 2016, the Division issued the following C&DIs:

- *Question 103.11 related to filing Schedules 13D and 13G (Rule 13d-1)* — Addresses whether a shareholder is exempt from filing Schedule 13G on the basis of the provisions in the Hart-Scott-Rodino Act.
- *Question 111.02 and Question 125.13 related to Securities Act sections and forms* — Contain questions related to an issuer's representation about the absence of a distribution of the securities received in an exchange.
- *Question 140.02 related to Regulation S-K* — Discusses how, in situations in which "a selling security holder is not a natural person," a registrant should "satisfy the obligation in Item 507 of Regulation S-K to disclose the nature of any position, office, or other material relationship that the selling security holder has had within the past three years with the registrant or any of its predecessors or affiliates."

In June 2016, the Division updated Section 271 of its C&DIs on rules related to the Securities Act. The updated guidance addresses questions about the completion of a merger transaction.

SEC Proposes Amendments to Broker-Dealers' Disclosures About Order Handling Information

In July 2016, the SEC issued a proposed rule that would enhance the requirements related to broker-dealers' disclosures about order handling information. Specifically, the proposal would require broker-dealers to "disclose the handling of institutional orders to customers" and to include additional information in their existing retail order disclosures.

For more information, see the press release on the SEC's Web site.

SEC Proposes Amendments to the Definition of Smaller Reporting Company

In June 2016, the SEC issued a proposed rule that "would expand the number of companies that qualify as smaller reporting companies, thus qualifying for certain existing scaled disclosures provided in Regulation S-K and Regulation S-X." Specifically, the proposal would increase the qualification threshold from less than $75 million of public float to less than $250 million. Further, companies with public float of zero "would be permitted to provide scaled disclosures if [their] annual revenues are less than $100 million, as compared to the current threshold of less than $50 million in annual revenues."

For more information, see Deloitte's June 29, 2016, journal entry and the press release on the SEC's Web site.

Thinking It Through

The proposal does not change the $75 million public float threshold in the SEC's definition of "accelerated filer." Therefore, a company could qualify as a smaller reporting company and be eligible for the scaled disclosures but may also be an accelerated filer and subject to those requirements, including the shorter deadlines for periodic filings and the requirement to include an auditor's attestation report on ICFR.

FAST Act Amends JOBS Act and SEC Disclosure Requirements

The FAST Act became law in December 2015. Among its many provisions, it amends the JOBS Act and certain SEC disclosure requirements as well as establishes a new statutory exemption for private resales of securities. Specific provisions of the FAST Act include those related to JOBS Act changes for IPOs of emerging growth companies (EGCs), Form 10-K and Regulation S-K disclosure changes, a new Section 4(a)(7) exemption for private resales, incorporation by reference for smaller reporting companies, and an amendment to registration thresholds applicable to savings and loan holding companies.

For more information, see Deloitte's December 8, 2015, journal entry as well as the announcement on the SEC's Web site.

Thinking It Through

The aim of this legislation is make it easier for EGCs to gain exposure to the capital markets to access funding by easing regulations related to when an EGC can begin its road show as well as the omission of certain historical financial information to the extent that such information is not expected to be required at the time of an IPO's effectiveness.

SEC Releases Guidance Related to FAST Act

In January 2016, the SEC issued interim final rules and form amendments to implement certain provisions of the FAST Act. Among other aspects, the rules revise Forms S-1 and F-1 to permit an EGC to omit financial information from registration statements filed before an IPO (or confidentially submitted to the SEC for review) for historical periods required by Regulation S-X if the EGC reasonably believes that it will not be required to include these historical periods at the time the contemplated offering becomes effective. The rules and amendments became effective on January 19, 2016.

In addition, in December 2015, the SEC issued a number of C&DIs related to the FAST Act. Topics addressed in the C&DIs include (1) whether, and in what circumstances, an EGC can omit interim financial statements or financial statements of other entities from its registration statement and (2) FAST Act requirements that affect savings and loan holding companies.

See Deloitte's December 8, 2015, journal entry for more information about the FAST Act's effects on securities laws and regulations. Also see Deloitte's January 15, 2016, journal entry for further details on the interim final rules and January 12, 2016, and December 18, 2015, journal entries for more information about the C&DIs.

SEC Adopts Rules to Implement FAST Act and JOBS Act Provisions

In May 2016, the SEC issued a final rule that (1) marks the completion of the Commission's rulemaking mandates under the JOBS Act and (2) implements provisions of the FAST Act. Specifically, the final rule:

- Amends "Exchange Act Rules 12g-1 through 12g-4 and 12h-3 which govern the procedures relating to registration and termination of registration under Section 12(g), and suspension of reporting obligations under Section 15(d), to reflect the new thresholds established by the JOBS Act and the FAST Act."
- Applies "the definition of 'accredited investor' in Securities Act Rule 501(a) to determinations as to which record holders are accredited investors for purposes of Exchange Act Section 12(g)(1)." The final rule also revises the definition of "held of record" and establishes a nonexclusive safe harbor under Exchange Act Section 12(g).

The final rule became effective on June 9, 2016. For more information, see the press release on the SEC's Web site.

In June 2016, the SEC issued an interim final rule that implements provisions mandated by the FAST Act. The interim final rule allows Form 10-K filers to provide a summary of business and financial information contained in the annual report. The rule indicates that "a registrant may, at its option, include a summary in its Form 10-K provided that each item in the summary includes a cross-reference by hyperlink to the material contained in the registrant's Form 10-K to which such item relates." In addition, the rule solicits comments on whether it should (1) include specific requirements or guidance related to the form and content of the summary and (2) be expanded to include other annual reporting forms. The interim final rule became effective on June 9, 2016.

For more information on the interim final rule, see Deloitte's June 2, 2016, journal entry and the press release on the SEC's Web site.

Thinking It Through

The SEC considered the interim final rule's effects on registrants and noted that the rule was not likely to significantly alter their current disclosure practices. SEC rules do not currently prohibit registrants from voluntarily including a summary in their Form 10-K; however, on the basis of the SEC staff's review of select Form 10-K filings, most do not include such a summary. Instead, the vast majority of registrants include a fully hyperlinked table of contents that allows users to easily navigate to corresponding disclosure items.

SEC and Other Organizations Propose Guidance on Incentive-Based Compensation Arrangements

In May 2016, the SEC and several other government agencies, including the Federal Reserve Board, OCC, FDIC, FHFA, and NCUA, jointly issued a proposed rule on incentive-based compensation arrangements to implement Section 956 of the Dodd-Frank Act. The proposed rule would:

- Prohibit "incentive-based payment arrangements that the Agencies determine encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss."
- Require "financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator."

For more information, see the press release on the SEC's Web site.

SEC Updates *Financial Reporting Manual*

In March 2016, the Division updated its Financial Reporting Manual to clarify or add guidance on the following topics:

- *Paragraph 2410.8* — Significance testing related to equity method investments.
- *Topic 10* — Requirements as a result of the FAST Act.
- *Topic 11* — Implementation of the FASB's and IASB's new revenue standard.

In November 2016, the Division updated its Financial Reporting Manual to clarify or add guidance on the following topics:

- *Paragraphs 1140.3 and 10220.7* — The number of years of a target company's financial statements that an EGC should present.
- *Paragraph 1330.5* — Filings required after Form 10 is effective.
- *Paragraph 5120.1* — Effect of loss of smaller reporting company status on accelerated filer determination and filing due dates.
- *Paragraph 8110.2* — The May 2016 C&DI updates on non-GAAP financial measures.
- *Paragraph 10220.5* — EGC guidance on the financial statements of entities other than the registrant; pro forma information.
- *Paragraph 11120.4, Index* — Implementation of the FASB's and IASB's new revenue standard.
- *Section 11200, Index* — Implementation of the FASB's and IASB's new leases standard.
- *Section 11300, Index* — Implementation of the FASB's new standard on disclosures about short-duration insurance contracts.

For more information, see Deloitte's March 22, 2016, and November 9, 2016, journal entries.

SEC and FDIC Issue Proposed Rule on Covered Broker-Dealer Provisions

In February 2016, the SEC and FDIC issued a proposed rule that establishes certain "provisions applicable to the orderly liquidation of covered brokers and dealers." The proposal is being issued in response to a mandate of the Dodd-Frank Act.

SEC Publishes Examination Priorities for 2016

In January 2016, the SEC's Office of Compliance Inspections and Examinations published its examination priorities for 2016. New priorities include liquidity controls, public pension advisers, product promotion, exchange-traded funds, and variable annuities. Further, the priorities "reflect a continuing focus on protecting investors in ongoing risk areas such as cybersecurity, microcap fraud, fee selection, and reverse churning."

For more information, see the press release on the SEC's Web site.

2015 AICPA Conference on Current SEC and PCAOB Developments

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, numerous speakers and discussion panels shared their insights into current accounting, reporting, and auditing practice issues. Key topics addressed at the event included the following:

- *Disclosure effectiveness* — Speakers focused on improving disclosure requirements, with the goal of enhancing the information provided to investors and promoting efficiency, competition, and capital formation. The SEC reiterated its continued focus on disclosure effectiveness, including its outreach to the investor community and its ongoing collaboration with the FASB.
- *ICFR* — This topic continues to be a key focus for regulators, preparers, and auditors. SEC Chief Accountant James Schnurr stated that "[m]anagement's ability to fulfill its financial reporting responsibilities depends, in large part, on the design and effectiveness of internal control over financial reporting." Several speakers commented that the frequency of ICFR-related findings in PCAOB inspections highlights the need for management, auditors, and audit committees to work together to address potential underlying issues with controls and assessments.
- *IFRSs* — The SEC's consideration of the potential incorporation of IFRSs into the U.S. financial reporting system has long been a topic at the conference, and this year was no exception. At the 2014 conference, Mr. Schnurr introduced a potential fourth alternative regarding the use of IFRSs in the United States that would allow U.S.-based filers to voluntarily provide supplemental IFRS-based information without reconciliation to U.S. GAAP. In his remarks at the 2015 conference, Mr. Schnurr indicated that the OCA is likely to recommend that the SEC consider and commence rulemaking that is consistent with this fourth alternative.
- *Audit committees* — Speakers observed that the roles and responsibilities now frequently imposed on audit committees in addition to their core SEC-required duties may interfere with their primary responsibility of overseeing the company's financial reporting. Mr. Schnurr recapped the SEC staff's efforts over the past year to address "whether investors are interested in hearing from audit committees on *how* (not just *if*) they have fulfilled their responsibilities; and . . . whether the Commission's rules support such reporting." As part of these efforts, the SEC issued a concept release in July 2015 to seek feedback on the proposed changes to the reporting requirements as well as on additional disclosures investors may want.

For more information, see Deloitte's December 15, 2015, *Heads Up*.

SEC Proposes Rule on Use of Derivatives

In December 2015, the SEC issued a proposed rule on use of derivatives by registered investment companies and business development companies. The proposal would "place restrictions on funds, such as mutual funds and exchange-traded funds . . . that would limit their use of derivatives and require funds to put in place risk management measures resulting in better protection for investors."

For more information, see the press release on the SEC's Web site.

SEC Proposes Enhancements to Disclosure Requirements for Alternative Trading Systems

In November 2015, the SEC issued a proposed rule that would amend the requirements for alternative trading systems under the Exchange Act. Specifically, the proposal would require alternative trading systems that "trade stocks listed on a national securities exchange (NMS stocks), including 'dark pools,' to publicly disclose detailed information about the operations and activities of a broker-dealer operator and its affiliates."

For more information, see the press release on the SEC's Web site.

Summary of Accounting Pronouncements Effective in 2016

The table below lists ASUs that became effective for calendar year 2016. (Note that it is assumed that the ASUs were not early adopted before 2016 if early adoption was permitted.)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2016-03, *Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance* — a consensus of the Private Company Council (March 2016)	Private entities.	Not applicable.	Upon issuance.
ASU 2015-16, *Simplifying the Accounting for Measurement-Period Adjustments* (September 2015)	Entities that have reported provisional amounts for items in a business combination for which the accounting is incomplete by the end of the reporting period in which the business combination occurs and during the measurement period have an adjustment to provisional amounts recognized.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017.

(Table continued)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2015-12, *(Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient* — consensuses of the FASB Emerging Issues Task Force (July 2015)	Reporting entities within the scope of ASC 960, ASC 962, or ASC 965. Effective for fiscal years beginning after December 15, 2015.		
ASU 2015-10, *Technical Corrections and Improvements* (June 2015)	All entities.	Transition guidance varies on the basis of the amendments in the ASU. The amendments that require transition guidance are effective for all entities for fiscal years and interim periods within those fiscal years beginning after December 15, 2015.	
ASU 2015-09, *Disclosures About Short-Duration Contracts* (May 2015)	All insurance entities that issue short-duration contracts as defined in ASC 944. The amendments do not apply to the holder (i.e., policyholder) of short-duration contracts.	Fiscal years beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.	Fiscal years beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017.
ASU 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* — a consensus of the FASB Emerging Issues Task Force (May 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years (and interim periods therein) beginning after December 15, 2016.
ASU 2015-06, *Effects on Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions* — a consensus of the FASB Emerging Issues Task Force (April 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	
ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* (April 2015)	All entities.	Annual periods (and interim periods therein) beginning after December 15, 2015.	Annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.

(Table continued)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2015-04, *Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets* (April 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017.
ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs* (April 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.
ASU 2015-02, *Amendments to the Consolidation Analysis* (February 2015)	Entities that are required to evaluate whether they should consolidate certain legal entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017.
ASU 2015-01, *Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items* (January 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	
ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination* — a consensus of the Private Company Council (December 2014)	All entities **except** public business entities and not-for-profit entities, as those terms are defined in the ASC master glossary.	Not applicable.	If the first in-scope transaction occurs in the first fiscal year beginning after December 15, 2015, the elective adoption will be effective for that fiscal year's annual financial reporting and all interim and annual periods thereafter. If the first transaction occurs in fiscal years beginning after December 15, 2016, the elective adoption will be effective in the interim period that includes the date of the transaction and subsequent interim and annual periods thereafter.

(Table continued)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2014-16, *Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force (November 2014)	Entities that are issuers of, or investors in, hybrid financial instruments that are issued in the form of a share.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.
ASU 2014-13, *Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity* — a consensus of the FASB Emerging Issues Task Force (August 2014)	A reporting entity that is required to consolidate a collateralized financing entity under the variable interest entities subsections of ASC 810-10 and that measures assets and liabilities of the collateralized financing entity by using fair value.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years ending after December 15, 2016, and interim periods beginning after December 15, 2016.
ASU 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period* — a consensus of the FASB Emerging Issues Task Force (June 2014)	Reporting entities that grant their employees share-based payments in which the terms of the award stipulate that a performance target that affects vesting could be achieved after the requisite service period.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	

Appendixes

Appendix A — Glossary of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

AICPA

Working Draft: Engineering & Construction Contractors Revenue Recognition Implementation Issues; Issue #4-1: Identifying the Unit of Account

FASB ASUs

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* — a consensus of the Emerging Issues Task Force

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*

ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*

ASU 2016-07, *Investments — Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*

ASU 2016-03, *Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance* — a consensus of the Private Company Council

ASU 2016-02, *Leases (Topic 842)*

ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*

ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*

ASU 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*

ASU 2015-12, *Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): (Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient* — consensuses of the FASB Emerging Issues Task Force

ASU 2015-10, *Technical Corrections and Improvements*

ASU 2015-09, *Financial Services — Insurance (Topic 944): Disclosures About Short-Duration Contracts*

ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-06, *Earnings per Share (Topic 260): Effects on Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-05, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*

ASU 2015-04, *Compensation — Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets*

ASU 2015-03, *Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*

ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*

ASU 2015-01, *Income Statement — Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*

ASU 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* — a consensus of the Private Company Council

ASU 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-13, *Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-12, *Compensation — Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements* — a consensus of the Private Company Council

ASU 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach* — a consensus of the Private Company Council

ASU 2014-02, *Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill* — a consensus of the Private Company Council

ASU 2014-01, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* — a consensus of the FASB Emerging Issues Task Force

ASU 2010-20, *Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*

ASU 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*

ASU 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities*

FASB ASC Topics and Subtopics

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 250-10, *Accounting Changes and Error Corrections: Overall*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321-10, *Investments — Equity Securities: Overall*

ASC 325-40, *Investments — Other: Beneficial Interests in Securitized Financial Assets*

ASC 326-30, *Financial Instruments — Credit Losses: Available-for-Sale Debt Securities*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360-20, *Property, Plant, and Equipment: Real Estate Sales*

ASC 460, *Guarantees*

ASC 470-10, *Debt: Overall*

ASC 470-20, *Debt: Debt With Conversion and Other Options*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 480-10, *Distinguishing Liabilities From Equity: Overall*

ASC 505-50, *Equity: Equity-Based Payments to Non-Employees*

ASC 605, *Revenue Recognition*

ASC 605-20, *Revenue Recognition: Services*

ASC 605-45, *Revenue Recognition: Principal Agent Considerations*

ASC 605-50, *Revenue Recognition: Customer Payments and Incentives*

ASC 606, *Revenue From Contracts With Customers*

ASC 606-10, *Revenue From Contracts With Customers: Overall*

ASC 610-20, *Other Income: Gains and Losses From the Derecognition of Nonfinancial Assets*

ASC 715, *Compensation — Retirement Benefits*

ASC 715-20, *Compensation — Retirement Benefits: Defined Benefit Plans — General*

ASC 718, *Compensation — Stock Compensation*

ASC 718-20, *Compensation — Stock Compensation: Awards Classified as Equity*

ASC 740, *Income Taxes*

ASC 740-10, *Income Taxes: Overall*

ASC 805, *Business Combinations*

ASC 805-10, *Business Combinations: Overall*

ASC 810, *Consolidation*

ASC 810-10, *Consolidation: Overall*

ASC 815, *Derivatives and Hedging*

ASC 815-10, *Derivatives and Hedging: Overall*

ASC 815-15, *Derivatives and Hedging: Embedded Derivatives*

ASC 815-40: *Derivatives and Hedging: Contracts in Entity's Own Equity*

ASC 820, *Fair Value Measurement*

ASC 820-10, *Fair Value Measurement: Overall*

ASC 825, *Financial Instruments*

ASC 825-10, *Financial Instruments: Overall*

ASC 840, *Leases*

ASC 845-10, *Nonmonetary Transactions: Overall*

ASC 860, *Transfers and Servicing*

ASC 932-10, *Extractive Activities — Oil and Gas: Overall*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 958, *Not-for-Profit Entities*

ASC 960, *Plan Accounting — Defined Benefit Pension Plans*

ASC 962, *Plan Accounting — Defined Contribution Pension Plans*

ASC 965, *Plan Accounting — Health and Welfare Benefit Plans*

ASC 970, *Real Estate — General*

ASC 970-605, *Real Estate — General: Revenue Recognition*

FASB Proposed ASUs

Proposed ASU 2016-360, *Compensation — Stock Compensation (Topic 718) — Scope of Modification Accounting*

Proposed ASU 2016-320, *Technical Corrections and Improvements to Update No. 2014-09, Revenue From Contracts With Customers (Topic 606) — Additional Corrections*

Proposed ASU 2016-310, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

Proposed ASU 2016-270, *Income Taxes (Topic 740): Disclosure Framework — Changes to the Disclosure Requirements for Income Taxes*

Proposed ASU 2016-250, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

Proposed ASU 2016-240, *Technical Corrections and Improvements to Update 2014-09, Revenue From Contracts With Customers (Topic 606)*

Proposed ASU 2016-230, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment*

Proposed ASU 2016-210, *Compensation — Retirement Benefits — Defined Benefit Plans —General (Subtopic 715-20): Changes to the Disclosure Requirements for Defined Benefit Plans*

Proposed ASU 2015-350, *Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement*

Proposed ASU 2015-330, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

Proposed ASU 2015-340, *Government Assistance (Topic 832): Disclosures by Business Entities About Government Assistance*

Proposed ASU 2015-300, *Conceptual Framework for Financial Reporting — Chapter 3: Qualitative Characteristics of Useful Financial Information*

Proposed ASU 2015-310, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*

Proposed ASU 2015-280, *Investments — Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting*

Other FASB Proposals

Invitation to Comment 2016-290, *Agenda Consultation*

Proposed Concepts Statement 2015-300, *Conceptual Framework for Financial Reporting: Chapter 3: Qualitative Characteristics of Useful Financial Information*

Proposed Concepts Statement 2014-200, *Conceptual Framework for Financial Reporting: Chapter 8: Notes to Financial Statements*

Invitation to Comment 2012-220, *Disclosure Framework*

FASB Concepts Statement

CON 8, *Conceptual Framework for Financial Reporting*

EITF Issue

15-F, "Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments"

Private Company Council Literature

PCC Issue No. 15-02, "Applying Variable Interest Entity Guidance to Entities Under Common Control"

SEC Division of Corporation Finance *Financial Reporting Manual*

Topic 2, "Other Financial Statements Required"; Section 2400, "Equity Method Investments, Including Fair Value Option"

Topic 10, "Emerging Growth Companies"

Topic 11, "Reporting Issued Related to Adoption of New Revenue Recognition Standard"

Topic 13, "Effects of Subsequent Events on Financial Statements Required in Filings"

SEC Regulation AB (Asset-Backed Securities)

Item 1101(c), "Definitions; Asset-Backed Security"

SEC Regulation S-X

Rule 4-08(h), "General Notes to Financial Statements: Income Tax Expense"

SEC Regulation S-K

Item 402(c), "Executive Compensation; Summary Compensation Table"

Item 402(u), "Executive Compensation; Pay Ratio Disclosure"

Item 507, "Selling Security Holders"

SEC Final Rules

34-78961, *Standards for Covered Clearing Agencies*

34-78716, *Access to Data Obtained by Security-Based Swap Data Repositories*

IA-4509, *Form ADV and Investment Advisers Act Rules*

34-78321, *Regulation SBSR — Reporting and Dissemination of Security-Based Swap Information*

34-78011, *Trade Acknowledgment and Verification of Security-Based Swap Transactions*

33-10075, *Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act*

34-77617, *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*

SIPA-175, *Securities Investor Protection Corporation*

34-77104, S*ecurity-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer* De Minimis *Exception*

SEC Interim Final Rules

34-77969, Request for Comment, *Form 10-K Summary*

33-10003, Request for Comment, *Simplification of Disclosure Requirements for Emerging Growth Companies and Forward Incorporation by Reference on Form S-1 for Smaller Reporting Companies*

SEC Proposed Rules and Concept Releases

34-78963, *Definition of "Covered Clearing Agency"*

34-78962, *Amendment to Securities Transaction Settlement Cycle*

34-78309, *Disclosure of Order Handling Information*

33-10110, *Disclosure Update and Simplification*

IA-4439, *Adviser Business Continuity and Transition Plans*

33-10107, *Amendments to Smaller Reporting Company Definition*

33-10064, *Business and Financial Disclosure Required by Regulation S-K*

34-77776, *Incentive-Based Compensation Arrangements*

34-77157, *Covered Broker-Dealer Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*

IC-31933, *Use of Derivatives by Registered Investment Companies and Business Development Companies*

34-76474, *Regulation of NMS Stock Alternative Trading Systems*

33-9862, *Possible Revisions to Audit Committee Disclosures*

Other SEC Proposal

33-10198, *Request for Comment on Subpart 400 of Regulation S-K Disclosure Requirements Relating to Management, Certain Security Holders and Corporate Governance Matters*

SEC Staff Accounting Bulletin

SAB Topic 13, "Revenue Recognition"

SEC Office of Compliance Inspections and Examinations

Examination Priorities for 2016

SEC C&DI Topics

Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting

Non-GAAP Financial Measures

Regulation AB and Related Rules

Regulation S-K

Securities Act Forms

Securities Act Rules

Securities Act Sections

Securities Act of 1933 Rule

Rule 501(a), "Definitions and Terms Used in Regulation D; Accredited Investor"

Securities Exchange Act of 1934 Rules

Rule 10b-10 "Manipulative and Deceptive Devices and Contrivances; Confirmation of Transactions"

Rule 12g "Extensions and Temporary Exemptions":

- Rule 12g-1, "Definitions; Exemption From Section 12(g)"
- Rule 12g-2, "Securities Deemed to Be Registered Pursuant to Section 12(g)(1) Upon Termination of Exemption Pursuant to Section 12(g)(2) (A) or (B)"
- Rule 12g-3, "Registration of Securities of Successor Issuers Under Section 12(b) or 12(g)"
- Rule 12g-4, "Certifications of Termination of Registration Under Section 12(g)"

Rule 12h-3, "Suspension of Duty to File Reports Under Section 15(d)"

Rule 13n-4, "Regulation SBSR; Duties and Core Principles of Security-Based Swap Data Repository"

International Standards

IFRS 16, *Leases*

IAS 17, *Leases*

IAS 12, *Income Taxes*

Appendix B — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
AOCI	accumulated other comprehensive income
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
AUP	agreed-upon procedures
BOLI	bank-owned life insurance
C&DI	SEC compliance and disclosure interpretation
CACM	consistently applied compensation measure
CECL	current expected credit loss
COLI	corporate-owned life insurance
DTA	deferred tax asset
DTL	deferred tax liability
EGC	emerging growth company
EITF	Emerging Issues Task Force
EPS	earnings per share
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FINRA	Financial Industry Regulatory Authority
GAAP	generally accepted accounting principles

Abbreviation	Description
GP	general partner
HTM	held to maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IPO	initial public offering
LP	limited partner
NCUA	National Credit Union Administration
NMS	National Market System
NOL	net operating loss
OCA	SEC's Office of the Chief Accountant
OCC	Office of the Comptroller of the Currency (U.S. Department of the Treasury)
OCI	other comprehensive income
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCD asset	purchased financial assets with credit deterioration
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SAC	subjective acceleration clause
SBS	security-based swap
SEC	Securities and Exchange Commission

Abbreviation	Description
SIFMA	Securities Industry and Financial Markets Association
SIPC	Securities Investor Protection Corporation
TRG	transition resource group
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
FAST Act	Fixing America's Surface Transportation Act
Hart-Scott-Rodino Act	Hart-Scott-Rodino Antitrust Improvements Act
Investment Advisers Act	Investment Advisers Act of 1940
JOBS Act	Jumpstart Our Business Startups Act
Securities Act	Securities Act of 1933

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In This Issue

Forecasting Revenue Disclosures — Storm Brewing?

by Joe DiLeo and Eric Knachel, Deloitte & Touche LLP

Introduction

When implementing the FASB's revenue standard (ASU 2014-09[1]), some companies will need to make wholesale changes to their income statements as a result of the new recognition and measurement requirements. For other companies, the impact of those requirements will be less significant. However, all entities will need to carefully consider the standard's new and modified quantitative and qualitative disclosure requirements.

This *Heads Up* discusses certain of the disclosure requirements that may be particularly challenging for entities to implement. For a comprehensive discussion of the new standard, including an analysis of other potential implementation issues, see Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*.

The Importance of an Entity's Disclosure Implementation Strategy

Some companies may not intend to consider the revenue standard's new disclosure requirements until perhaps early 2018, after the new standard becomes effective (i.e., as part of the first-quarter reporting process for public business entities). However, such a strategy might be risky for a number of reasons.

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

Significant Increase in Necessary Information

The new standard will require entities to disclose much more information about revenue activities and related transactions than they do currently. Consequently, they will need time to implement and test appropriate processes, internal controls, and disclosure controls and procedures (including the identification of relevant personnel and information systems throughout the organization) for (1) data-gathering activities, (2) the identification of applicable disclosures on the basis of relevance and materiality, and (3) the preparation and review of disclosures, including the information that supports such disclosures.

Annual Disclosures Needed in First Quarterly Filing

Although the new revenue standard specifies that certain disclosures are not required in interim financial statements, SEC registrants, in accordance with SEC rules and staff interpretations, will be required to provide both annual and interim disclosures in the first interim period after the adoption of new accounting standards and in each subsequent quarter in the year of adoption. Specifically, Section 1500 of the SEC Financial Reporting Manual states:

> S-X Article 10 requires disclosures about material matters that were not disclosed in the most recent annual financial statements. Accordingly, when a registrant adopts a new accounting standard in an interim period, the registrant is expected to provide both the annual and the interim period financial statement disclosures prescribed by the new accounting standard, to the extent not duplicative. These disclosures should be included in each quarterly report in the year of adoption.

As a result, a calendar-year-end SEC registrant will need to comply with the new revenue standard's full suite of disclosure requirements in each quarter, beginning with its first quarter ended March 31, 2018, to the extent that the disclosures are material and do not duplicate information.

Reporting Deadlines, Compliance, and Internal Controls

The requirement to consider disclosures as part of preparing quarterly or year-end financial statements most likely will significantly affect an entity's ability to meet reporting deadlines that are already tight (particularly for SEC filings). In addition, an entity may be unable to obtain the information it needs to satisfy the disclosure requirements (e.g., because of problems related to the collection, preparation, or review of data needed for disclosures), which could result in late filings and the identification of deficiencies in internal controls (e.g., material weaknesses).

Disclosures That May Be Challenging to Implement

Performance Obligations (Including Remaining Performance Obligations)

In contrast to current guidance, the new revenue standard introduces a series of quantitative and qualitative disclosure requirements related to performance obligations that will be partially or entirely new for many entities. Under these requirements, entities must disclose:

- Qualitative information about the types of performance obligations, the nature of goods and services promised, and when the obligations are typically satisfied.
- Qualitative information about significant payment terms, warranties, and refund obligations.
- Quantitative and qualitative information about amounts allocated to remaining performance obligations, and when such remaining amounts will be recognized as revenue.
- Information about significant financing components and variable consideration.
- Performance obligations for which the entity acts as an agent.

It may be difficult for companies to determine the level at which to present information about their performance obligations and the nature of goods or services. Complying with the requirements related to remaining performance obligations (commonly referred to as "backlog disclosures") may be particularly challenging because of difficulties associated with identifying the remaining performance obligations. Further, determining when remaining performance obligations are expected to be satisfied is a matter of judgment, and the information disclosed may therefore be subjective.

Other aspects of the disclosure requirements related to performance obligations that may pose difficulties in an entity's implementation include:

- Identifying amounts and related drivers of variable consideration associated with performance obligations (including information regarding the estimation of variable consideration and any related constraints on the variable consideration and their potential effects on future cash flows).
- Assessing whether material rights exist, and the manner in which those rights would be disclosed within the context of other distinct performance obligations.

Significant Judgments and Estimates

An entity is required to make significant judgments and estimates as it applies the new revenue standard's five-step model (e.g., the determination of variable consideration and whether to constrain variable consideration). Accordingly, the new standard requires disclosures about those judgments and estimates, including the following:

Qualitative Information About Determining the Timing of:	Qualitative and Quantitative Information (Including Methods, Inputs, and Assumptions Used) About:
• Performance obligations satisfied over time (e.g., methods of measuring progress, why methods are representative of transfer of goods or services, judgments used in the evaluation of when a customer obtains control of goods or services). • Performance obligations satisfied at a point in time — specifically, the significant judgments used in the evaluation of when a customer obtains control.	• Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration). • Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration. • Constraining estimates of variable consideration. • Measuring obligations for returns, refunds, and other similar obligations.

In a manner similar to the accounting related to significant estimates and the exercise of judgment under other areas of U.S. GAAP, an entity may need to revise its original revenue estimates. Therefore, it is crucial for the entity to maintain effective internal controls and documentation that support the assumptions and judgments that underpin its estimates. Disclosures about out-of-period revenues that result from changes in estimates of variable consideration (i.e., whether actual revenue earned is more or less than what was originally estimated) are likely to attract attention from stakeholders (e.g., investors and analysts) because, for analysts and investors that use 20/20 hindsight to gauge the reliability of a company's revenue estimates, they highlight the company's ability to make estimates and the effectiveness of its related controls.

Contract Balances (Contract Assets and Liabilities)

Along with guidance that requires entities to recognize contract assets and liabilities in certain circumstances, the new standard adds disclosure requirements related to such contract balances. The required information is tantamount to a rollforward of contract assets and liabilities (i.e., the standard requires disclosure of the beginning and ending balances as well as significant movements in the balances). Disclosures of significant movements would include performance obligations that have been satisfied in the period and qualitative and quantitative information that results from out-of-period revenues (e.g., changes to estimates of variable consideration). However, the standard does not prescribe a specific format, and therefore presentation may be in the form of a true rollforward or in a narrative or other format.

To comply with the disclosure requirements related to contract balances — particularly those that apply to capturing out-of-period revenues — an entity may need to develop processes and controls for identifying and tracking the following information:

- The timing of satisfaction of performance obligations (see Performance Obligations (Including Remaining Performance Obligations) above).
- Payment terms that may give rise to contract balances.
- Transactions that may affect contract balances, such as business combinations or divestitures.
- Material changes in estimates (as discussed above in Significant Judgments and Estimates).
- Other information that an entity may not have previously tracked.

Disaggregation of Revenue

Entities should consider the standard's overall disaggregation principle in ASC 606-10-50-2.[2] The guidance in ASC 606-10-50-2 prescribes neither methods of aggregation or disaggregation nor the form or format of disclosures, but it does indicate that aggregation or disaggregation of revenue information should occur so that "useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics." More specifically, the new standard contains guidance on the disaggregation of entities' contracts with their customers that requires entities to (1) disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors and (2) provide sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information.

For example, companies need to disclose, at a minimum under the new standard, (1) revenues for products and services and (2) contracts for which revenue is recognized at a point in time and over time. Further, entities may consider the following factors in "reconciling" disaggregated revenue disclosures with segment disclosures:

- Broader categories of goods or services.
- Types of customers.
- Geographical regions and markets in which the entities' goods and services are sold.
- Information reviewed by the chief operating decision makers.
- Disclosures in other of the entities' external communications.

Because there is no prescribed format or method for applying the new standard's disaggregation principles, disclosures will be entity-specific and, accordingly, a company will need to exercise significant judgment in determining the appropriate level of disaggregation. Consequently, it will be important for an entity to determine what information will be useful for key stakeholders such as investors, lenders, and regulatory bodies and which form of presentation (e.g., tabular or text) will be more effective in achieving the disclosure principles.

[2] FASB Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers*.

Next Steps

For public business entities with a calendar-year-end, there is less than a year before the new revenue standard is effective. In addition, many companies still have much work to do to implement the standard's recognition and measurement guidance and little time left to do it. Therefore, entities are encouraged not to wait but to assess the disclosure requirements simultaneously with their implementation of the standard's recognition and measurement principles.

As a company analyzes each disclosure requirement, it should consider materiality, relevance, the information that will be needed, how to get that information, and the controls necessary for the preparation and review of the disclosures and the related underlying data. Because a company can use similar information (or information from similar sources) to comply with some of the disclosure requirements (e.g., information related to performance obligations and estimates of variable consideration), the company should develop a comprehensive strategy to collect the information and draft disclosures that effectively and efficiently describe its revenue "story."

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Financial reporting developments

A comprehensive guide

Revenue from contracts with customers (ASC 606)

Revised August 2016

Building a better working world

To our clients and other friends

In May 2014, the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) (collectively, the Boards) issued largely converged revenue recognition standards that will supersede virtually all revenue recognition guidance in US GAAP and IFRS.

The standards provide accounting guidance for all revenue arising from contracts with customers and affect all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP or IFRS requirements, such as lease requirements). The standards also specify the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers (see Section 9.3) and provide a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate (see Chapter 11).

As a result, the standards will likely affect entities' financial statements, business processes and internal control over financial reporting. While some entities will be able to implement the standards with limited effort, others may find implementation to be a significant undertaking. Successful implementation will require an assessment and a plan for managing the change. Beginning in 2018, US GAAP public entities, as defined, and IFRS preparers will need to apply the standards.

Recently, the Boards amended their respective standards to address several implementation issues raised by constituents. The Boards did not agree on the nature and breadth of all of the changes to their revenue standards; however, the Boards expect the amendments to result in similar outcomes in many circumstances.

This publication summarizes the FASB's standard and highlights significant differences from the IASB's standard. It addresses all of the amendments the FASB has finalized to date, along with topics on which the members of the Transition Resource Group for Revenue Recognition (TRG) reached general agreement. It also discusses our views on certain topics, including those that are based on our understanding of the views of the FASB and/or its staff and the staff of the Securities and Exchange Commission (SEC).

We also have issued industry-specific publications that address significant changes to legacy industry accounting. We encourage preparers and users of financial statements to read this publication and the industry supplements carefully and consider the potential effects of the new standard.

The views we express in this publication may continue to evolve as implementation continues and additional issues are identified. Conclusions in seemingly similar situations may differ from those reached in the illustrations due to differences in the underlying facts. We expect to periodically update our guidance to provide the latest implementation insights. Please see EY AccountingLink for our most recent revenue publications.

Ernst + Young LLP

August 2016

Contents

Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

Changes to the standards since issuance

In May 2014, the FASB and the IASB issued largely converged revenue recognition standards that will supersede virtually all revenue recognition guidance in US GAAP and IFRS.[1] Since then, the Boards have finalized various amendments to their respective standards, as summarized below. Throughout the publication, we highlight these amendments and discuss the amended guidance. The Boards did not agree on the nature and breadth of all of the changes to their respective revenue standards; however, the Boards have said they expect the amendments to result in similar outcomes in many circumstances.

In addition to deferring the effective date of the standard (see Section 1.2) by one year to give entities more time to implement it, the FASB has issued the following Accounting Standards Updates (ASUs) to address implementation issues (many of which were discussed by the TRG).

The FASB issued ASU 2016-08 in March 2016 to amend the principal versus agent guidance as follows (see Section 4.4):

- Clarify how an entity should identify the unit of accounting (i.e., the specified good or service) for the principal versus agent evaluation
- Clarify how the control principle applies to certain types of arrangements such as service transactions by explaining what a principal controls before the specified good or service is transferred to the customer
- Clarify how the control principle relates to the indicators by reframing the indicators to focus on a principal rather than an agent relationship
- Revise the original examples in the standard and add new ones

The FASB issued ASU 2016-10 in April 2016 to amend the licenses of intellectual property guidance as follows (see Chapter 8):

- Clarify that when determining whether to recognize revenue from granting a license of intellectual property over time, entities will consider whether the licensor undertakes activities that significantly affect the intellectual property's "utility" and generally recognize revenue from the licensed intellectual property over time if the intellectual property does not have significant standalone functionality
- Require entities to classify intellectual property in one of two categories (i.e., functional or symbolic) after considering the nature of the intellectual property and the licensor's expected activities related to the intellectual property
- Clarify how the sales- and usage-based royalty constraint is applied in certain circumstances
- Clarify the accounting for license renewals and restrictions

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[1] ASU 2014-09 (largely codified in Accounting Standards Codification (ASC) 606) and IFRS 15. Throughout this publication, when we refer to the FASB's standard, we mean ASC 606, unless otherwise noted. The ASUs the FASB has issued to change the new guidance amend ASC 606.

ASU 2016-10 also amended the guidance on identifying performance obligations as follows (see Sections 4.1 through 4.2):

- Clarify when a promised good or service is separately identifiable (i.e., distinct within the context of the contract)
- Allow entities to disregard items that are immaterial in the context of the contract
- Allow entities to elect to account for the cost of shipping and handling that is performed after control of a good has been transferred to the customer as a fulfillment cost (i.e., an expense)

The FASB issued ASU 2016-12 in May 2016 to make narrow-scope improvements and add practical expedients in the following areas:

- Collectibility — Clarify that the objective of the collectibility threshold is to assess an entity's exposure to credit risk for the goods and services that will be transferred to the customer and when an entity should recognize revenue for nonrefundable consideration received from the customer when the arrangement does not meet the criteria to be accounted for as a revenue contract under the standard (see Sections 3.1.5 and Section 3.5)
- Noncash consideration — Clarify that the fair value of noncash consideration should be measured at contract inception and that the constraint on variable consideration applies only to the variability of noncash consideration due to reasons other than the form of the consideration (see Section 5.6)
- Presentation of sales (and other similar) taxes — Allow an entity to make an accounting policy election to exclude from the transaction price certain types of taxes collected from a customer (i.e., present revenue net of these taxes) (see Section 5.1)
- Transition — Provide a practical expedient to account for contract modifications executed prior to adoption of the new standard that can be used under either transition method, clarify that an entity that uses the full retrospective method does not need to disclose the effect of the accounting change on affected financial statement line items in the period of adoption and clarify that a completed contract is one for which all (or substantially all) of the revenue was recognized under legacy GAAP (see Section 1.3)

In May 2016, the FASB proposed nine technical corrections and improvements related to its revenue standard.[2] We highlight these when applicable throughout this publication. Included in this proposal is an additional practical expedient that would allow an entity not to disclose variable consideration allocated to unsatisfied performance obligations in certain situations, primarily when an estimate would be made solely for disclosure purposes (see Section 10.4.1). Comments were due 2 July 2016. To finalize these changes, the FASB will need to issue a final ASU.

The IASB also deferred the effective date of its standard by one year, which keeps the standards' effective dates converged under IFRS and US GAAP. Early adoption is permitted for IFRS preparers, including first-time adopters of IFRS, provided that fact is disclosed. In April 2016, the IASB finalized amendments to its revenue standard to address principal versus agent considerations, identifying performance obligations, licenses of intellectual property and certain practical expedients on transition. The IASB's amendments for principal versus agent considerations and clarifying when a promised good or service is separately identifiable when identifying performance obligations are converged with those of the FASB discussed above. The IASB's other amendments were not the same as those of the FASB. We highlight these differences throughout this publication.

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[2] Proposed ASU, *Technical Corrections and Improvements to Update No. 2014-09, Revenue from Contracts with Customers (Topic 606)*, issued 18 May 2016.

1 Overview, effective date and transition

1.1 Overview

The revenue recognition standards the Boards issued in May 2014 were largely converged and will supersede virtually all revenue recognition guidance in US GAAP[3] and IFRS. The Boards' goal in joint deliberations was to develop revenue standards that would:

- Remove inconsistencies and weaknesses in the legacy revenue recognition literature in both US GAAP and IFRS
- Provide a more robust framework for addressing revenue recognition issues
- Improve comparability of revenue recognition practices across industries, entities within those industries, jurisdictions and capital markets
- Reduce the complexity of applying revenue recognition guidance by reducing the volume of the relevant guidance
- Provide more useful information to investors through new disclosure requirements

The standards provide accounting guidance for all revenue arising from contracts with customers and affect all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP or IFRS requirements, such as lease requirements). The standards also specify the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers (see Section 9.3) and provide a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate (see Chapter 11).

As a result, the standards will likely affect entities' financial statements, business processes and internal control over financial reporting. While some entities will be able to implement the new standards with limited effort, others may find implementation to be a significant undertaking. Successful implementation will require an assessment and a plan for managing the change.

The standards the Boards issued in 2014 were converged except for a handful of differences.[4] Since then, the Boards have finalized some converged amendments to their standards (i.e., principal versus agent considerations and clarifying when a promised good or service is separately identifiable when identifying performance obligations), but they have also finalized different amendments regarding the accounting for licenses of intellectual property and transition. The FASB has also finalized amendments relating to immaterial goods and services in a contract, accounting for shipping and handling, collectibility, noncash consideration and the presentation of sales and other similar taxes that the IASB has not. We highlight

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[3] The SEC staff has been reviewing its revenue guidance in light of the new standard and has rescinded four SEC Staff Observer comments on narrow issues related to revenue effective upon adoption of the new standard. However, it hasn't yet addressed what will happen with SAB Topic 13.

[4] As originally issued, the standards under US GAAP and IFRS were identical except for these areas: (1) the Boards used the term "probable" to describe the level of confidence needed when assessing collectibility to identify contracts with customers, which will result in a lower threshold under IFRS than US GAAP; (2) the FASB required more interim disclosures than the IASB; (3) the IASB allowed early adoption; (4) the FASB did not allow reversals of impairment losses and the IASB did; and (5) the FASB provided relief for nonpublic entities relating to specific disclosure requirements and the effective date.

these differences throughout this publication. However, the primary purpose of this publication is to highlight the FASB's standard, including all amendments to date, and focuses on the effects for US GAAP preparers.[5] As such, we generally refer to the singular "standard."

The TRG, which the FASB and the IASB formed to help them determine whether more guidance was needed to address implementation questions and to educate constituents, discussed many of the topics the Boards addressed in their amendments along with many other topics. TRG members include financial statement preparers, auditors and users from a variety of industries, countries and public and private entities. Members of the TRG met six times in 2014 and 2015. In January 2016, the IASB announced that it did not plan to schedule further meetings of the IFRS constituents of the TRG but said it will monitor any discussions of the US GAAP group, which met in April 2016 and is scheduled to meet again in November 2016.

While the TRG members' views are non-authoritative, entities should consider them as they implement the new standards. The SEC's Chief Accountant has previously made public statements that he expects SEC registrants to use the TRG discussions and meeting minutes to inform their implementation of the standards and has said that his office strongly encourages registrants, including foreign private issuers, that want to use accounting that differs from TRG discussions to discuss their accounting with the SEC staff.[6] We have incorporated our summaries of topics on which TRG members generally agreed throughout this publication. Unless otherwise specified, these summaries represent the discussions of the joint TRG.

1.1.1 Core principle of the standard

The standard describes the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle, as stated below, is that an entity will recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Objectives

606-10-10-1

The objective of the guidance in this Topic is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue **and cash flows arising from a** contract **with a** customer**.**

Meeting the Objective

606-10-10-2

To meet the objective in paragraph 606-10-10-1, the core principle of the guidance in this Topic is that an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

606-10-10-3

An entity shall consider the terms of the **contract** and all relevant facts and circumstances when applying this guidance. An entity shall apply this guidance, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances.

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[5] For more information on the effect of IFRS 15 for IFRS preparers, refer to our *Applying IFRS: A closer look at the new revenue recognition standard*.

[6] Speech by James V. Schnurr, 22 March 2016. Refer to SEC website at http://www.sec.gov/news/speech/schnurr-remarks-12th-life-sciences-accounting-congress.html.

The principles in the standard will be applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

Entities will need to exercise judgment when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. Entities will have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. The FASB included more than 60 examples in the standard to illustrate how an entity might apply the new guidance. We list them in Appendix F to this publication and provide references to where certain examples are included in this publication.

1.2 Effective date

FASB amendments

In August 2015, the FASB issued ASU 2015-14 that deferred by one year the standard's effective dates for US GAAP public and nonpublic entities, as defined.

Due to the one-year deferral, the standard is effective for public entities, as defined, for fiscal years beginning after 15 December 2017 and for interim periods therein. Nonpublic entities are required to adopt the standard for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. That is, nonpublic entities are not required to apply the standard in interim periods in the year of adoption.

Public and nonpublic entities will be permitted to adopt the standard as early as the original public entity effective date (i.e., annual reporting periods beginning after 15 December 2016 and interim periods therein). Early adoption prior to that date is not permitted.

The standard includes the following effective date guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Transition and Open Effective Date Information

Transition Related to Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606)

606-10-65-1

The following represents the transition and effective date information related to Accounting Standards Updates No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* and Accounting Standards Update No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net),* and No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing,* and No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients:*

a. A **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission shall apply the pending content that links to this paragraph for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

b. All other entities shall apply the pending content that links to this paragraph for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. However, all other entities may elect to apply the pending content that links to this paragraph earlier only as of either:

1. An annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period.

2. An annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the pending content that links to this paragraph.

IASB differences

The IASB also deferred the effective date of its standard by one year. As a result, IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2018. Early adoption is permitted for IFRS preparers, including first-time adopters of IFRS, provided that fact is disclosed. While the effective dates generally are converged under IFRS and US GAAP, IFRS 15 allows early adoption prior to the date permitted by the FASB standard. In addition, IFRS 15 does not distinguish between public and nonpublic entities so adoption is not staggered for IFRS preparers.

1.2.1 Definition of a 'public' entity

The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following:

- A public business entity (PBE)
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files or furnishes financial statements with the SEC

The standard uses the same definition of a PBE as ASU 2013-12. That is, a business entity (which would not include a not-for-profit entity or an employee benefit plan) is a PBE if it meets any of the following criteria:[7]

- "(a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

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[7] See our Technical Line, *A closer look at the new definition of a public business entity* (BB2708).

- (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion."

An entity may meet the definition of a PBE solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a PBE for purposes of financial statements that are filed or furnished with the SEC.

An entity that does not meet any of the criteria above is considered a nonpublic entity for purposes of this standard.

How we see it

Because the standard applies to PBEs, certain non-issuer entities will likely be required to adopt the guidance sooner than they may have anticipated. That is because the definition of a PBE is broader than other definitions of public entities and publicly traded companies in US GAAP, and determining whether an entity is a PBE may require assistance from legal counsel. For example, the definition includes entities whose financial statements or financial information is furnished or filed in another entity's SEC filing.

These entities also will have to make public company disclosures that are more extensive than those for nonpublic entities (see Chapter 10).

1.2.2 Effective date for public and nonpublic entities

The table below illustrates the effective date of the standard for public and nonpublic entities with differing fiscal year ends and options for early adoption:

	Effective date		
Year end	**Public**	**Nonpublic**	**Options for early adoption**
31 December	1 January 2018, first present in 31 March 2018 Form 10-Q.	1 January 2019, first present in the financial statements for the year ended 31 December 2019. Present in interim financial statements starting 31 March 2020.	**Public:** ▸ 1 January 2017 adoption date, first present in 31 March 2017 Form 10-Q. **Nonpublic:** ▸ 1 January 2017 adoption date, first present in 31 March 2017 interim financial statements or first present in the financial statements for the year ended 31 December 2017. OR ▸ 1 January 2018 adoption date, first present in 31 March 2018 interim financial statements or first present in the financial statements for the year ended 31 December 2018. OR ▸ 1 January 2019 adoption date, first present in 31 March 2019 interim financial statements.

	Effective date		
Year end	**Public**	**Nonpublic**	**Options for early adoption**
31 March	1 April 2018, first present in 30 June 2018 Form 10-Q.	1 April 2019, first present in the financial statements for the year ended 31 March 2020. Present in interim financial statements starting 30 June 2020.	**Public:** ▸ 1 April 2017 adoption date, first present in 30 June 2017 Form 10-Q. **Nonpublic:** ▸ 1 April 2017 adoption date, first present in 30 June 2017 interim financial statements or first present in the financial statements for the year ended 31 March 2018. OR ▸ 1 April 2018 adoption date, first present in 30 June 2018 interim financial statements or first present in the financial statements for the year ended 31 March 2019. OR ▸ 1 April 2019 adoption date, first present in 30 June 2019 interim financial statements.
30 June	1 July 2018, first present in 30 September 2018 Form 10-Q.	1 July 2019, first present in the financial statements for the year ended 30 June 2020. Present in interim financial statements starting 30 September 2020.	**Public:** ▸ 1 July 2017 adoption date, first present in 30 September 2017 Form 10-Q. **Nonpublic:** ▸ 1 July 2017 adoption date, first present in 30 September 2017 interim financial statements or first present in the financial statements for the year ended 30 June 2018. OR ▸ 1 July 2018 adoption date, first present in 30 September 2018 interim financial statements or first present in the financial statements for the year ended 30 June 2019. OR ▸ 1 July 2019 adoption date, first present in 30 September 2019 interim financial statements.

	Effective date		
Year end	Public	Nonpublic	Options for early adoption
30 September	1 October 2018, first present in 31 December 2018 Form 10-Q.	1 October 2019, first present in the financial statements for the year ended 30 September 2020. Present in interim financial statements starting 31 December 2020.	**Public:** ▸ 1 October 2017 adoption date, first present in 31 December 2017 Form 10-Q. **Nonpublic:** ▸ 1 October 2017 adoption date, first present in 31 December 2017 interim financial statements or first present in the financial statements for the year ended 30 September 2018. OR ▸ 1 October 2018 adoption date, first present in 31 December 2018 interim financial statements or first present in the financial statements for the year ended 30 September 2019. OR ▸ 1 October 2019 adoption date, first present in 31 December 2019 interim financial statements.

1.3 Transition method

FASB amendments

In May 2016, the FASB issued ASU 2016-12 that (1) added a transition practical expedient for contract modifications, (2) clarified that an entity that uses the full retrospective method does not need to disclose the effect of the accounting change on affected financial statement line items in the period of adoption as would otherwise be required by ASC 250, (3) amended the definition of a "completed contract" and (4) allowed an entity to apply the modified retrospective method to all contracts (rather than only to completed contracts).

The standard requires retrospective application. However, it allows either a "full retrospective" adoption in which the standard is applied to all of the periods presented or a "modified retrospective" adoption.

The standard includes the following transition guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Transition and Open Effective Date Information

Transition Related to Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606)

606-10-65-1

c. For the purposes of the transition guidance in (d) through (i):

1. The date of initial application is the start of the reporting period in which an entity first applies the pending content that links to this paragraph.

   2. A completed **contract** is a contract for which all (or substantially all) of the **revenue** was recognized in accordance with **revenue** guidance that is in effect before the date of initial application.

d. An entity shall apply the pending content that links to this paragraph using one of the following two methods:

   1. Retrospectively to each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10 subject to the expedients in (f).

   2. Retrospectively with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the date of initial application in accordance with (h) through (i).

e. If an entity elects to apply the pending content that links to this paragraph retrospectively in accordance with (d)(1), the entity shall provide the disclosures required in paragraphs 250-10-50-1 through 50-2 in the period of adoption, except as follows. An entity need not disclose the effect of the changes on the current period, which otherwise is required by paragraph 250-10-50-1(b)(2). However, an entity shall disclose the effect of the changes on any prior periods that have been retrospectively adjusted.

f. An entity may use one or more of the following practical expedients when applying the pending content that links to this paragraph retrospectively in accordance with (d)(1):

   1. An entity need not restate contracts that begin and are completed within the same annual reporting period.

   2. For completed contracts that have variable consideration, an entity may use the **transaction price** at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

   3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining **performance obligations** and an explanation of when the entity expects to recognize that amount as revenue (see paragraph 606-10-50-13).

   4. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the pending content that links to this paragraph, an entity need not retrospectively restate the contract for those contract modifications in accordance with paragraphs 606-10-25-12 through 25-13. Instead, an entity shall reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented in accordance with the pending content that links to this paragraph when:

      a. Identifying the satisfied and unsatisfied performance obligations

      b. Determining the transaction price

      c. Allocating the transaction price to the satisfied and unsatisfied performance obligations.

g. For any of the practical expedients in (f) that an entity uses, the entity shall apply that expedient consistently to all contracts within all reporting periods presented. In addition, the entity shall disclose all of the following information:

   1. The expedients that have been used

   2. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

h. If an entity elects to apply the pending content that links to this paragraph retrospectively in accordance with (d)(2), the entity shall recognize the cumulative effect of initially applying the pending content that links to this paragraph as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) of the annual reporting period that includes the date of initial application. Under this transition method, an entity may elect to apply this guidance retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application (for example, January 1, 2018, for an entity with a December 31 year-end). An entity shall disclose whether it has applied this guidance to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application. Under this transition method, an entity may apply the practical expedient for contract modifications in (f)(4). If an entity applies the practical expedient for contract modifications in (f)(4), it shall comply with the guidance in (g).

i. For reporting periods that include the date of initial application, an entity shall disclose the nature of and reason for the change in accounting principle and provide both of the following additional disclosures if the pending content that links to this paragraph is applied retrospectively in accordance with (d)(2):

   1. The amount by which each financial statement line item is affected in the current reporting period by the application of the pending content that links to this paragraph as compared with the guidance that was in effect before the change

   2. An explanation of the reasons for significant changes identified in (i)(1).

For purposes of applying the transition requirements, the Board clarified the following terms in ASC 606-10-65-1 above:

- The *date of initial application* is the start of the reporting period in which an entity first applies the new guidance. For example, for a public entity with a fiscal year end of 31 December that does not adopt the standard early, the date of initial application will be 1 January 2018, regardless of the transition method selected.

- A *completed contract* is a contract for which all (or substantially all) of the revenue was recognized under legacy GAAP that was in effect before the date of initial application. Elements of a contract that do not affect revenue under legacy GAAP are not considered when assessing whether a contract is complete. Consider the following examples:

  - Contract is completed — A retailer sells products to a customer on 31 December 2017. Under its loyalty rewards program, the retailer gives customers points based on the amounts they spend. Customers can redeem these points for discounts on future purchases. Under legacy GAAP, the retailer follows the incremental cost accrual model and recognizes revenue at the time of the initial sale (i.e., 31 December 2017) plus an accrual for the expected costs of satisfying the award credits. Because all (or substantially all) of the revenue related to this sale has been recognized under legacy GAAP prior to the date of initial application of the new standard (e.g., 1 January 2018), the contract is considered completed under the new standard.

  - Contract is NOT completed — An entity licenses software to a customer on 1 January 2017 with extended payment terms that are not a standard business practice. The customer is required to make payments in three annual installments beginning 31 December 2017. Legacy GAAP for software revenue generally required entities that provide extended payment terms to defer revenue until future installment payments are due because the fees are presumed to not be fixed or determinable because a significant portion of the fee is not due for more than a year after delivery. As of the date of initial application of the new standard (e.g., 1 January 2018), the entity has recognized revenue only for the first installment payment. Because all (or substantially all) of the revenue has not been recognized under legacy GAAP, the contract is not considered completed under the new standard.

The Board also explained in the Background Information and Basis for Conclusions of ASU 2106-12[8] that it included the phrase "substantially all" in the definition of a completed contract because it did not intend to exclude all contracts for which less than 100% of the revenue was recognized under legacy GAAP (e.g., because of a sales return reserve).

IASB differences

The definition of a "completed contract" is not converged between US GAAP and IFRS. A completed contract under IFRS 15 "is a contract for which the entity has transferred all of the goods or services identified in accordance with IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations."

1.3.1 Full retrospective adoption

Entities electing full retrospective adoption will apply the standard to each period presented in the financial statements in accordance with the accounting changes guidance in ASC 250-10-45-5 through 45-10, subject to the practical expedients created to provide relief, as discussed below. This means entities will have to apply the standard as if it had been in effect since the inception of all its contracts with customers presented in the financial statements. That is, an entity electing the full retrospective method would have to transition all of its contracts with customers to the standard (subject to the practical expedients described below), not just those contracts that are not considered completed as of the beginning of the earliest period presented under the standard at the date of initial application. This means that for contracts that were considered completed (as defined) before the beginning of the earliest period presented under the standard, an entity would still need to evaluate the contract under the standard in order to determine whether there was an effect on revenue recognition in any of the year's presented in the income statement upon transition (e.g., 2016, 2017, 2018). During its deliberations on the original standard, the FASB seemed to prefer the full retrospective method under which all contracts with customers are recognized and measured consistently in all periods presented within the financial statements, regardless of contract inception. This method also provides users of the financial statements with useful trend information across all periods presented.

However, to ease the potential burden of a full retrospective application, the FASB provided the following relief:

- An entity is not required to restate revenue from contracts that begin and are completed within the same annual reporting period. For example, a December year-end public entity that adopts the standard on 1 January 2018 does not have to apply the standard to any contract that began and was completed within 2016 or began and was completed within 2017 (i.e., all or substantially all of the revenue related to that contract was recorded within one fiscal year).
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed, rather than estimating variable consideration amounts in the comparative reporting periods. That is, an entity may use hindsight when considering variable consideration for purposes of determining the transaction price for completed contracts. Chapter 5 discusses determining the transaction price under the new model.

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[8] Paragraph BC52 of ASU 2016-12.

- For all reporting periods presented before the date of initial application, as defined above, an entity is not required to disclose the amount of the transaction price allocated to the remaining performance obligations or when the entity expects to recognize that amount as revenue. This is discussed further in Section 10.4.1.

Only entities that elect the full retrospective transition method can use the practical expedients described above.

The following practical expedient can be used by entities that elect either transition method:

- For contracts modified prior to the beginning of the earliest reporting period presented under the new standard (e.g., 1 January 2016 for a public entity electing the full retrospective method), an entity can reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented under the new standard when identifying the satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to the satisfied and unsatisfied performance obligations for the modified contract at transition.

  An entity that uses this expedient will have to identify all contract modifications from the inception of the contract until the beginning of the earliest period presented under the new standard and determine how each modification affected the identification of performance obligations as of the modification date. However, the entity would not need to determine or allocate the transaction price as of the date of each modification. Instead, at the beginning of the earliest period presented under the standard, the entity would determine the transaction price for all satisfied and unsatisfied performance obligations identified in the contract from contract inception to the beginning of the earliest period presented and then perform a single allocation of the transaction price to those performance obligations, based on their relative standalone selling prices.

The FASB acknowledged in the Basis for Conclusions of ASU 2016-12[9] that even with this practical expedient, an entity will need to use judgment and make estimates to account for contract modifications at transition. For example, an entity will need to use judgment in estimating standalone selling prices when there has been a wide range of selling prices and when allocating the transaction price to satisfied and unsatisfied performance obligations if there have been several performance obligations or contract modifications over an extended period. Further, an entity will be required to apply the standard's contract modification guidance (see Section 3.4) to modifications made after the beginning of the earliest period presented under the new standard.

IASB differences

IFRS 15 includes a similar practical expedient for contract modifications at transition for entities that elect to apply the full retrospective method. These entities also would apply the IASB's practical expedient to all contract modifications that occur before the beginning of the earliest period presented in the financial statements. However, this could be a different date between US GAAP and IFRS preparers depending on the number of comparative years included in an entity's statements (e.g., IFRS preparers often include only one comparative year in their financial statements).

IFRS 15 also provides a practical expedient that the FASB's standard does not. It allows an entity that uses the full retrospective method to apply the new standard only to contracts that are not completed (as defined) as of the beginning of the earliest period presented.

[9] Paragraph BC46 of ASU 2016-12.

Entities can decide to apply some, all or none of these expedients. However, if an entity uses any of them, it must apply that expedient consistently to all contracts within all periods presented. For example, it would not be appropriate to apply the selected expedient to some but not all of the periods presented. Entities that choose to use some or all of the relief will be required to provide additional qualitative disclosures (i.e., explain which types of relief the entity applied and the likely effects of that application).

An entity that elects to apply the full retrospective method also must provide the disclosures required in ASC 250-10-50-1 through 50-2 as excerpted below (with certain exceptions):

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections — Overall

Disclosure

Change in Accounting Principle

250-10-50-1

An entity shall disclose all of the following in the fiscal period in which a **change in accounting principle** is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

   1. A description of the prior-period information that has been retrospectively adjusted, if any.

   2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

   3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

   4. If **retrospective application** to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If **indirect effects of a change in accounting** principle are recognized both of the following shall be disclosed:

   1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable.

   2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

250-10-50-2

An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

Under ASC 606-10-65-1(e), an entity that elects to apply the full retrospective method is *not required* to disclose the effect of the changes on the current period (e.g., 2018 for a calendar year-end public entity that does not early adopt), as would otherwise be required by ASC 250-10-50-1(b)(2). These entities still will be required to disclose the effect of the changes on any prior periods that have been retrospectively adjusted (e.g., 2016 and 2017 for a calendar year-end public entity that does not early adopt) in accordance with ASC 250-10-50-1(b)(2).

ASC 250-10-50-1 requires an entity to make these disclosures in the fiscal period in which a change in accounting principle is made. Financial statements of subsequent periods need not repeat the required disclosures initially made in the period of an accounting change. However, entities that issue interim financial statements must provide the required disclosures in the financial statements of both the interim and annual periods that include the direct or indirect effects of a change in accounting principle. For example, a public entity that makes a change in accounting principle in the first quarter of 20X8 must include the required disclosures in its first-, second- and third-quarter interim financial statements. The entity must also include the required disclosures for the annual period in its annual financial statements for 20X8. These disclosures are not required in the financial statements for any interim or annual periods after 20X8.

For the indirect effects of a change in accounting principle, an entity is required to disclose a description of the indirect effects, the amounts recognized in the current period and the related per-share amounts, as well as, if practicable, the total recognized indirect effects of the accounting change and the related per-share amounts attributable to each prior period presented.

1.3.2 Modified retrospective application

Entities that elect the modified retrospective method will apply the guidance retrospectively only to the most current period presented in the financial statements. To do so, the entity will have to recognize the cumulative effect of initially applying the standard as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) at the date of initial application.

An entity may elect to apply the modified retrospective method to either all contracts as of the date of initial application (i.e., 1 January 2018 for a public entity with a calendar year end that does not early adopt the standard) or only to contracts that are not completed as of this date. Depending on how an entity elects to apply the modified retrospective method, it will have to evaluate either all contracts or only those that are not completed before the date of initial application as if the entity had applied the new standard to them since inception. An entity will be required to disclose how it has applied the modified retrospective method (i.e., either to all contracts or only to contracts that are not completed at the date of initial application).

An entity may choose to apply the modified retrospective method to all contracts as of the date of initial application (rather than only to contracts that are not completed) in order to apply the same accounting to similar contracts after the date of adoption. For example, as discussed in Section 1.3, a sale by a retailer on 31 December 2017 that included loyalty rewards points accounted for as a cost accrual (rather than as a revenue element) would be considered a completed contract as of the date of initial application (e.g., 1 January 2018). If the retailer adopts the standard only for contracts that are not completed, it would not restate revenue for this contract and would continue to account for the loyalty points as a cost accrual under legacy GAAP after adoption of the new standard. However, for any similar sales on or after 1 January 2018, loyalty points will generally be identified as a performance obligation and revenue will be allocated to the points awarded and deferred at the time of sale (see Section 4.1).

Accordingly, if the retailer prefers to account for similar transactions under the same accounting model (i.e., rather than as cost accruals for points awarded prior to 1 January 2018 and revenue deferrals thereafter), it could choose to adopt the standard for all contracts that would have revenue recognized under the new standard. In the Basis for Conclusions of ASU 2016-12,[10] the FASB noted that the application of the modified retrospective method to all contracts could result in financial information that is more comparable with financial information provided by entities using the full retrospective method.

How we see it

Entities that use the modified retrospective method will need to make this election at the entity-wide level. That is, they will need to carefully consider whether to apply the standard to all contracts or only to contracts that are not completed as of the date of initial application, considering the totality of all of the entity's revenue streams and the potential disparity in accounting for the same or similar types of transactions after they adopt the standard.

Under the modified retrospective method, an entity will:

- Present comparative periods under legacy GAAP
- Apply the new revenue standard to new and existing contracts (either all existing contracts or only to contracts that are not completed contracts) as of the date of initial application
- Recognize a cumulative catch-up adjustment to the opening balance of retained earnings at the effective date for all contracts or only contracts that are not completed
- In the year of adoption, disclose the amount by which each financial statement line item was affected as a result of applying the new standard and an explanation of significant changes

As discussed above in Section 1.3.1, an entity that chooses the modified retrospective method can use only one of the four practical expedients available to entities that apply the full retrospective method. For contracts modified prior to the beginning of the earliest reporting period presented under the new standard (e.g., 1 January 2018), an entity can reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented under the new standard when identifying the satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to the satisfied and unsatisfied performance obligations for the modified contract at transition.

An entity that uses this expedient will have to identify all contract modifications from the inception of the contract until the beginning of the earliest period presented under the new standard and determine how each modification affected the identification of performance obligations as of the modification date. However, the entity would not need to determine or allocate the transaction price as of the date of each modification. Instead, at the beginning of the earliest period presented under the standard, the entity would determine the transaction price for all satisfied and unsatisfied performance obligations identified in the contract from contract inception to the beginning of the earliest period presented and then perform a single allocation of the transaction price to those performance obligations, based on their relative standalone selling prices.

If an entity electing the modified retrospective method uses the practical expedient for contract modifications, it will be required to provide additional qualitative disclosures (i.e., the type of relief the entity applied and the likely effects of that application).

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[10] Paragraph BC53 of ASU 2016-12.

The FASB acknowledged in the Basis for Conclusions of ASU 2016-12[11] that even with this practical expedient, an entity will need to use judgment and make estimates to account for contract modifications at transition. For example, an entity will need to use judgment in estimating standalone selling prices when there has been a wide range of selling prices and when allocating the transaction price to satisfied and unsatisfied performance obligations if there have been several performance obligations or contract modifications over an extended period. Further, an entity will be required to apply the standard's contract modification guidance (see Section 3.4) to modifications made after the beginning of the earliest period presented under the new standard.

IASB differences

As discussed above, IFRS 15 includes a similar practical expedient for contract modifications at transition; however, an entity can choose to apply the IASB's practical expedient when using the modified retrospective method either to all contract modifications that occur before the beginning of the earliest period presented in the financial statements or to all contract modifications that occur before the date of initial application.

The following example illustrates the potential effects of modified retrospective adoption:

Illustration 1-1: Cumulative effect of adoption under modified retrospective

A public entity software vendor with a 31 December fiscal year end adopts the standard as of 1 January 2018. The vendor selects the modified retrospective method for adoption and elects to apply it only to contracts that are not completed.

The vendor frequently enters into contracts to provide a software license, professional services and post-contract support (PCS) and previously accounted for its contracts in accordance with ASC 985-605. Further, the vendor did not have vendor-specific objective evidence (VSOE) of the fair value for the PCS and, as a result, recognized the contract consideration ratably over the PCS period.

Under the new guidance, the vendor would likely reach a different conclusion regarding the units of accounting than it did under ASC 985-605 because the standard does not require VSOE of fair value to treat promised goods and services as separate performance obligations (discussed further in Section 4.2).

As a result, the vendor's analysis of contracts that are not complete as of 1 January 2018 would likely result in the identification of different performance obligations from the units of accounting it previously identified for revenue recognition. As part of this assessment, the entity would need to allocate the estimated transaction price based on the relative standalone selling price method (see Section 6.2) to the newly identified performance obligations.

The vendor would compare the revenue recognized for each contract from contract inception through 31 December 2017 to the amount that would have been recognized if it had applied the standard since contract inception. The difference between those amounts would be accounted for as a cumulative effect adjustment and recognized on 1 January 2018. Beginning on 1 January 2018, the amount of revenue recognized would be based on the new guidance.

[11] Paragraph BC46 of ASU 2016-12.

Regardless of the transition method selected, an entity is required to disclose the nature and reason for the change in accounting principle. In addition, an entity that elects to apply the modified retrospective method will be required to make certain disclosures in the year of initial application, including in interim periods. Specifically, the entity must disclose the amount by which each financial statement line item is affected as a result of applying the new standard. Further, an entity must disclose a qualitative explanation of the significant changes between the reported results under the new revenue recognition standard and the prior revenue recognition guidance.

How we see it

Depending on an entity's prior accounting, applying the modified retrospective method may be more difficult than the entity anticipates. Entities may encounter situations that likely will make this application more complex, including:

- The performance obligations identified under the new guidance are different from the separate units of accounting identified under legacy GAAP.
- The relative selling price allocation under the new guidance results in different amounts being allocated to performance obligations than had been allocated in the past.
- The contract contains variable consideration, and the amount of variable consideration that can be included in the allocable consideration differs from the amount under legacy GAAP.

Entities should also consider that the modified retrospective method effectively requires an entity to keep two sets of accounting records in the year of adoption in order to comply with the requirement to disclose all line items in the financial statements as if they were prepared under legacy GAAP.

1.3.3 Other transition considerations

Regardless of the transition method they select, many entities will have to apply the guidance to contracts they entered into in prior periods. The population of contracts will likely be larger under the full retrospective method; however, under the modified retrospective method, entities will at a minimum have to apply the guidance to all contracts that are not completed as of the initial application date, regardless of contract inception. Questions on the mechanics of retrospective application are likely to arise.

In addition, while the Board provided some relief from a full retrospective method in the form of four practical expedients and provided the option of a modified retrospective method with one practical expedient, there are still a number of implementation issues that may make transitioning to the new standard difficult and time-consuming.

For example:

- For full retrospective adoption, entities likely will be required to perform a relative standalone selling price allocation if there are changes to the identified units of accounting, the transaction price or both. If an entity previously performed a relative selling price allocation (e.g., when the transaction was accounted for under ASC 605-25), performing this step will likely be straightforward. However, if an entity did not previously perform a relative selling price allocation, an entity will be required to determine the standalone selling price of each performance obligation as of contract inception. Depending on the age of the contract, this information may not be readily available, and the prices may differ significantly from current standalone selling prices. While the standard is clear on when it is acceptable to use hindsight when considering variable consideration for purposes of determining the transaction price (see Section 5.2), the standard is silent on whether the use of hindsight is acceptable for other aspects of the model (e.g., for purposes of allocating the transaction price) or whether it would be acceptable to use current pricing information if that were the only information available.

- Estimating variable consideration for all contracts for the prior periods will likely require significant judgment. The standard does not permit the use of hindsight for contracts that are not completed when applying the full retrospective method. While the standard is silent on whether the use of hindsight is acceptable for entities applying the modified retrospective method, the FASB's discussion in the Basis for Conclusions of ASU 2014-09[12] implied that it originally intended to make no practical expedients available for the modified retrospective method. Further, since entities applying the modified retrospective method may only be adjusting contracts that are not completed, it seems likely that the use of hindsight is not acceptable. As a result, entities must make this estimate based only on information that was available at contract inception. Contemporaneous documentation clarifying what (and when) information was available to management will likely be needed to support these estimates. In addition to estimating variable amounts using the expected value or a most likely amount approach, entities will have to make conclusions about whether such variable amounts are subject to the constraint (see Section 5.2.3 for further discussion).
- The modified retrospective method does not require entities to recast the amounts reported in prior periods. However, entities electing this method will still have to calculate, as of the adoption date, either for all contracts or only for contracts that are not completed (depending on how the entity elects to apply this transition method), the revenues they would have recognized if they had applied the new guidance since contract inception to determine the cumulative effect of adopting the standard. This is likely to be most challenging for contracts for which the unit of accounting or allocable contract consideration changes when the new guidance is applied.

Finally, an entity will need to consider a number of other issues as it prepares to adopt the standard. For example, an entity with significant deferred revenue balances before the date of initial application may experience what some refer to as "lost revenue" if those amounts will ultimately, be reflected in the restated prior periods or as part of the cumulative adjustment upon adoption but are never reported as revenue in a current period.

1.3.4 Additional transition considerations for public entities

In addition to determining its adoption date and transition method, a public entity also will have to consider how it will address certain SEC requirements and staff guidance:

SAB Topic 11.M — This guidance requires entities to provide disclosures about the effects, to the extent those effects are known, of recently issued accounting standards in registration statements and periodic reports filed with the SEC. Public entities should consider the following disclosures within management's discussion and analysis (MD&A) and the financial statements:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier
- A discussion of the methods of adoption allowed by the standard and the method the registrant expects to use, if determined
- A discussion of the effect the standard is expected to have on the financial statements or, if the effect is not known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)

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[12] Paragraph BC441 of ASU 2014-09.

How we see it

The SEC staff has stated several times that it expects an entity's disclosures to evolve as more information about the effects of the new standard becomes available. That is, the SEC staff expects that an entity's transition disclosures will increase as a company progresses in its implementation plans. In addition, entities that don't yet know how they will be affected should disclose that the effect is unknown, along with information about when they plan to complete their assessment of how they will be affected.

These disclosures should provide users with detailed information about the adoption and should not include boilerplate language. We believe this may become a focus area for the SEC staff in its reviews of filings.

Selected financial data table[13] and ratio of earnings to fixed charges[14] — While the SEC staff's longstanding view has been that all periods in the five-year selected financial data table must be recast to give effect to the full retrospective adoption of a new accounting standard or change in accounting principle, the SEC staff updated its Financial Reporting Manual (FRM)[15] in March 2016 to state that it will not object if entities that elect full retrospective adoption of the standard do not recast the earliest two years in these disclosures. That is, the SEC staff will allow an entity to only adjust the table for the same years it presents in its primary financial statements (e.g., 2016, 2017 and 2018). Such entities will be required to include clear disclosure about the lack of comparability among the years in all instances. That is, registrants that elect full retrospective adoption and choose not to recast the earliest two years will need to disclose in a note to the table of selected financial data, or in a cross-referenced discussion, accounting changes that materially affect comparability among the years presented. A public entity that applies the standard using the modified retrospective method also will need to include clear disclosures on the lack of comparability, but it is not otherwise required to recast any year other than the current one.

The SEC staff also said in its FRM update that it would not object if entities that elect full retrospective adoption of the standard do not recast the earliest two years of the ratio of earnings to fixed charges requirements.

Registration statement requirements for previously issued financial statements — Item 11(b) of Form S-3 requires retrospective revision of the annual financial statements in a new or amended registration statement when a registrant adopts a new accounting principle retrospectively (i.e., following the full retrospective method under the new standard) and the change is considered material. For example, a calendar-year registrant filing a Form S-3 registration statement in 2018 after it adopts the revenue standard retrospectively in a Form 10-Q filing, but before it files the annual financial statements for the year of adoption, would be required to recast its prior-period annual financial statements (i.e., for 2015, 2016 and 2017). Absent this registration statement requirement, the entity would only have to recast its prior period financial statements for 2016 and 2017 when it files its full year 2018 10-K (which will include 2016, 2017 and 2018). This means that such an entity will need to recast an extra full year to reflect the effect of the new standard (i.e., 2015) just because it is filing a registration statement.

The recast financial statements (with accompanying MD&A and selected financial data) generally are filed in a Form 8-K and not an amended Form 10-K because the original financial statements did not contain errors.

The SEC staff has publicly discussed questions it has received about this requirement, specifically how it applies to adoption of the new revenue standard. The SEC staff acknowledged entities' concerns about having to recast an additional year of financial statements and reminded entities that the impracticability exception to retrospective application provided by ASC 250-10-45-9 can apply if the required criteria are

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[13] Item 301 of Regulation S-K.

[14] Item 503(d) of Regulation S-K.

[15] New Topic 11, *Reporting Issues Related to Adoption of New Revenue Recognition Standard*, of the SEC's Division of Corporation Finance's Financial Reporting Manual.

met. Entities are encouraged to consult with the SEC staff if they believe that, based on their facts and circumstances, a retrospective application of the new revenue recognition standard to all periods required to be presented in a Form S-3 is impracticable.

Similar considerations would apply to certain other Securities Act registration statements (e.g., Form S-1, Form S-4) when historical financial statements are incorporated by reference.

How we see it

If an entity knows that it will have a Form S-3 shelf registration statement that will expire in the same year as it adopts the new revenue standard, it can plan ahead and refresh that registration statement before adoption and avoid having to recast an additional year. That is, an entity can refresh a shelf registration statement at any time; it is not required to wait until the registration statement expires.

Financial information of equity method investees — Under Rules 3-09 and 4-08(g) of Regulation S-X, an equity method investee that was once insignificant could become significant because of a retrospective accounting change. While a registrant does not need to remeasure significance in any registration statement or proxy statement filed in the current fiscal year, under the current SEC rules, when the registrant files its next Form 10-K, it would have to recalculate significance of equity method investees for each fiscal year presented using the historical financial statements that are retrospectively revised for the accounting change.

Absent specific relief and depending on the level of significance based on the revised calculation, separate audited financial statements (under Rule 3-09) or summarized financial information (under Rule 4-08(g)) of the equity method investee could be required. However, in its March 2016 FRM update, the SEC staff said it would allow companies that adopt the revenue standard on a full retrospective basis to use their pre-adoption significance tests for evaluating the applicability of Rules 3-09 and 4-08(g) of Regulation S-X for periods before the date of initial application of the standard.

The SEC staff further stated in its March 2016 FRM update that registrants will not be required to conform the transition dates and methods of adopting (i.e., full or modified retrospective) the standard for equity method investees for purposes of computing the significance of equity method investees under Rules 3-09 and 4-08(g) of Regulation S-X.

Internal control over financial reporting (ICFR) disclosures — Public entities will also have to consider whether their implementation of new controls and processes related to adoption of the standard requires disclosure about material changes in ICFR under Item 308(c) of Regulation S-K.

Article 11 pro forma disclosures — In its March 2016 FRM update, the SEC staff said that the transition date and method of adopting (i.e., full or modified retrospective) the standard for significant acquired businesses must conform to those of the registrant when pro forma financial information is provided to comply with Article 11 of Regulation S-X.

2 Scope

The new guidance applies to all entities and all contracts with customers to provide goods or services in the ordinary course of business, except for contracts or transactions that are excluded from its scope, as described below:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Scope and Scope Exceptions

Entities

606-10-15-1

The guidance in this Subtopic applies to all entities.

Transactions

606-10-15-2

An entity shall apply the guidance in this Topic to all contracts with customers, except the following:

a. Lease contracts within the scope of Topic 840, Leases.

b. Insurance contracts within the scope of Topic 944, Financial Services—Insurance.

c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:

   1. Topic 310, Receivables
   2. Topic 320, Investments—Debt and Equity Securities
   3. Topic 323, Investments—Equity Method and Joint Ventures
   4. Topic 325, Investments—Other
   5. Topic 405, Liabilities
   6. Topic 470, Debt
   7. Topic 815, Derivatives and Hedging
   8. Topic 825, Financial Instruments
   9. Topic 860, Transfers and Servicing.

d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.

e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Topic would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis. Topic 845 on nonmonetary transactions may apply to nonmonetary exchanges that are not within the scope of this Topic.

606-10-15-3

An entity shall apply the guidance in this Topic to a contract (other than a contract listed in paragraph 606-10-15-2) only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

UPDATE: In May 2016, the FASB proposed amending ASC 606-10-15-2(b) to delete the word "insurance" and say only that "contracts" within the scope of ASC 944 are excluded from the scope of ASC 606. This proposal would address the fact that ASC 944 includes guidance for non-insurance investment contracts as well as insurance contracts. Comments were due 2 July 2016. To finalize this change, the FASB will need to issue a final ASU.

2.1 Other scope considerations

Certain agreements executed by entities include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the same or similar goods in the original agreement. The form of the repurchase agreement and whether the customer obtains control of the asset subject to the agreement will determine whether the agreement is within the scope of the standard. See Section 7.3 for a discussion on repurchase agreements.

Entities may enter into transactions that are partially within the scope of the new revenue recognition guidance and partially within the scope of other guidance. In these situations, the standard requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard. See Section 2.4 for further discussion.

The standard also provides guidance on the accounting for certain costs such as the incremental costs of obtaining a contract and the costs of fulfilling a contract. However, the standard requires that the guidance on costs of fulfilling a contract be applied only if there is no other guidance for accounting for these costs. See Section 9.3 for further discussion of the cost guidance in the new standard.

In addition, the consequential amendments associated with the standard include guidance on the recognition of a gain or loss on the transfer of certain nonfinancial assets (e.g., assets within the scope of ASC 360 and intangible assets within the scope of ASC 350). See Chapter 11 for further discussion.

2.2 Definition of a customer

The standard defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from CON 6, which refers to ordinary activities as an entity's "ongoing major or central operations." In many transactions, a customer is easily identifiable. However, in transactions involving multiple parties, it may be less clear which counterparties are customers of an entity. For some arrangements, multiple parties could be considered customers of the entity. However, for other arrangements, only one of the parties involved is considered a customer.

The illustration below shows how the party considered to be the customer may differ, depending on the arrangement:

Illustration 2-1: Identification of a customer

An entity provides internet-based advertising services to companies. As part of that service, the entity obtains banner space on various websites from a selection of publishers. For certain contracts, the entity provides a sophisticated service of matching the ad placement with the pre-identified criteria of the advertising party. In addition, the entity purchases the advertising space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the principal in these contracts (see Section 4.4 for further discussion of principal versus agent considerations). Accordingly, the entity identifies its customer in this transaction as the advertiser to whom it is providing services.

In other contracts, the entity simply matches advertisers with the publishers in its portfolio, but the entity does not provide any ad-targeting services or purchase the advertising space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the agent in these contracts. Accordingly, the entity identifies its customer as the publisher to whom it is providing services.

In addition, the identification of the performance obligations in a contract (discussed further in Chapter 4) can have a significant effect on the determination of which party is the entity's customer.

Also see the discussion of the identification of an entity's customer when applying the guidance on consideration paid or payable to a customer in Section 5.7.

2.3 Collaborative arrangements

In certain transactions, a counterparty may not be a "customer" of the entity. Instead, the counterparty may be a collaborator or partner that shares in the risks and benefits of developing a product to be marketed. These transactions, which are common in the pharmaceutical, biotechnology, oil and gas, and health care industries, generally are in the scope of ASC 808 on collaborative arrangements. However, depending on the facts and circumstances, these arrangements may also contain a vendor-customer aspect. Such arrangements could still be within the scope of the new revenue guidance, at least partially, if that collaborator or partner meets the definition of a customer for some or all aspects of the arrangement.

The FASB decided not to provide further guidance for determining whether certain revenue-generating collaborative arrangements would be in the scope of the new guidance. In the Basis for Conclusions of ASU 2014-09,[16] the FASB explained that it would not be possible to provide implementation guidance that applies to all collaborative arrangements. Therefore, the parties to such arrangements need to consider all of the facts and circumstances to determine whether a vendor-customer relationship exists that is subject to the new guidance.

However, the FASB did determine[17] that in some circumstances (e.g., when more relevant guidance that could be applied is not available), it may be appropriate for an entity to apply the principles in the new revenue standard to collaborations or partnerships.

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[16] Paragraph BC54 of ASU 2014-09.

[17] Paragraph BC56 of ASU 2014-09.

How we see it

Under legacy guidance, identifying the customer can be difficult, especially when multiple parties are involved in a transaction. This evaluation can require significant judgment, and the new guidance does not provide any additional considerations.

While transactions among collaboration partners that are in the scope of ASC 808 aren't in the scope of the new revenue guidance, ASC 808-10-45-3 states that when payments between parties in a collaboration are not within the scope of other authoritative accounting literature, the income statement classification should be based on an analogy to authoritative accounting literature or, if there is no appropriate analogy, a reasonable, rational and consistently applied accounting policy election. Therefore, ASC 808 allows an entity to apply the new revenue recognition guidance by analogy to these types of arrangements, if that is the policy it has elected.

2.4 Interaction with other guidance

Under legacy GAAP, entities entering into transactions that fall within the scope of multiple areas of accounting guidance have to separate those transactions into the elements that are accounted for under different pieces of literature. The new revenue guidance does not change this.

However, under legacy guidance, revenue transactions often must be separated into elements that are accounted for under different pieces of revenue guidance (e.g., a multiple-element transaction that falls within the scope of both the multiple-element arrangements guidance in ASC 605-25 and the construction-type and production-type contracts guidance in ASC 605-35). Under the new guidance, this separation will not be required because there is a single revenue recognition model.

The standard provides guidance for arrangements partially in its scope and partially in the scope of other standards as follows:

Excerpt from the Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Scope and Scope Exceptions

Transactions

606-10-15-4

A contract with a customer may be partially within the scope of this Topic and partially within the scope of other Topics listed in paragraph 606-10-15-2.

a. If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the **transaction price** the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics and shall apply paragraphs 606-10-32-28 through 32-41 to allocate the amount of the transaction price that remains (if any) to each **performance obligation** within the scope of this Topic and to any other parts of the contract identified by paragraph 606-10-15-4(b).

b. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply the guidance in this Topic to separate and/or initially measure the part (or parts) of the contract.

Only after applying any other applicable guidance will an entity apply the standard's revenue guidance to the remaining elements of an arrangement. Some examples of where separation and/or measurement are addressed in other literature include the following:

- ASC 460 provides that a liability should be recognized, based on the guarantee's estimated fair value, when a guarantee is issued as part of a multiple-element arrangement. Therefore, for contracts that include a guarantee and revenue elements, the fair value of the guarantee is deducted from the estimated contract consideration, and the remaining contract consideration is allocated among the other elements in the contract in accordance with the revenue recognition standard.
- Subsequent to the adoption of ASC 606, ASC 840 provides guidance on allocating an arrangement's consideration between the lease element (including related executory costs) and non-lease elements within a contractual arrangement that refers to the revenue guidance (i.e., ASC 606-10-15-4 and paragraphs 606-10-32-28 through 32-41). Accordingly, the arrangement consideration should be allocated between the elements within the scope of ASC 840 and any non-lease elements within the scope of other guidance (e.g., the revenue guidance) based on the relative standalone selling price of each element.

  In February 2016, the FASB issued a new leases standard (that is codified as ASC 842) that has similar requirements to those in ASC 840 for how lessors allocate arrangement consideration between lease and non-lease components using the allocation principles in ASC 606. The new leases standard is effective for public entities, as defined, for annual and interim periods beginning after 15 December 2018 (i.e., one year after the new revenue standard). For nonpublic entities, the effective date will be annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities.

If an element of the arrangement is covered by another ASC topic but that topic does not specify how to separate and/or initially measure that element, the entity will apply the revenue guidance for purposes of separation and/or measurement. For example, specific guidance does not exist on the separation and measurement of the different parts of an arrangement when an entity sells a business and also enters into a long-term supply agreement with the other party. Under legacy GAAP, entities account for these often complex arrangements in different ways. It is unclear how these arrangements will be accounted for under the new revenue standard. See Section 6.6 for further discussion of the effect on the allocation of arrangement consideration when an arrangement includes both revenue and non-revenue elements.

Question 2-1 **Should contracts that guarantee performance (e.g., when a contract contains a service level agreement (SLA)) be accounted for under ASC 460 or ASC 606?**

Consider an example in which an entity has a contract with a customer to operate a call center. The contract includes an SLA guaranteeing that the average service call response times will be below two minutes. If the call center does not meet the two minute average wait time, the entity will have to pay the customer a penalty.

ASC 606 specifically excludes from its scope contracts with customers for guarantees (other than product or service warranties discussed in Section 9.1) that are within the scope of ASC 460. As discussed above, ASC 606-10-15-4 also includes guidance on how to separate and measure a contract that is partially within the scope of ASC 606 and partially within the scope of other topics. Therefore, an entity must consider the scope of ASC 460 to determine whether a transaction falls within the scope of ASC 460, ASC 606 or partially between them. ASC 460-10-15-7(i) states that a guarantee or indemnification of an entity's own future performance is not within the scope of ASC 460.

Accordingly, because of the ASC 460-10-15-7(i) scope exception, contracts that guarantee an entity's own future performance do not contain a guarantee within the scope of ASC 460 and the entity should account for the contract under ASC 606. This contract provision will be accounted for as variable consideration (see Section 5.2).

Question 2-2 **Should contracts that include a profit margin guarantee be accounted for under ASC 460 or ASC 606?**

Consider an example in which a clothing manufacturer sells clothing to a retail store under a contract offering a refund of a portion of its sales price at the end of each season if the retailer has not met a minimum sales margin. The retail store takes title to the clothing and title remains with the retailer. The profit margin guarantee is agreed to at the inception of the contract and is a fixed amount.

As discussed in Question 2-1 above, the entity (i.e., the clothing manufacturer) will first consider whether the contract is in the scope of ASC 460. In this scenario, an entity would likely determine that such an arrangement would meet either (or both) of two scope exceptions in ASC 460. ASC 460-10-15-7(e) states that a contract that "provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party" is excluded from the scope of ASC 460. ASC 460-10-15-7(g) states that "a guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction" also is excluded from the scope of ASC 460.

Accordingly, we believe contracts that include a profit margin guarantee not contain a guarantee within the scope of ASC 460 and the entity should account for the contract under ASC 606. This contract provision will be accounted for as variable consideration (see Section 5.2).

Question 2-3 **Are certain fee-generating activities of financial institutions in the scope of the new revenue standard (i.e., servicing and sub-servicing financial assets, providing financial guarantees and providing deposit-related services)?** [18 April FASB TRG meeting; agenda paper no. 52]

FASB TRG members generally agreed that the standard provides a framework for determining whether certain contracts are in the scope of ASC 606 or other guidance. As discussed above, the standard's scope includes all contracts with customers to provide goods or services in the ordinary course of business, except for contracts with customers that are within the scope of certain other ASC topics that are listed in ASC 606-10-15-2. If the guidance in another ASC topic specifies the accounting for the consideration (e.g., a fee) received in the arrangement, the consideration is outside the scope of ASC 606. If the guidance in other ASC topics does not specify the accounting for the consideration and there is a separate good or service provided, the consideration is in (or at least partially in) the scope of ASC 606. The FASB staff applied this framework in the TRG agenda paper to arrangements to service financial assets, provide financial guarantees and provide deposit-related services.

FASB TRG members generally agreed that income from servicing financial assets (e.g., loans) *is not in the scope* of ASC 606. An asset servicer performs various services, such as communication with the borrower and payment collection, in exchange for a fee. FASB TRG members generally agreed that an entity should look to ASC 860 to determine the appropriate accounting for these fees. This is because ASC 606 contains a scope exception for contracts that fall under ASC 860, which provides guidance on the accounting for the fees (despite not providing explicit guidance on revenue accounting).

FASB TRG members generally agreed that fees from providing financial guarantees *are not in the scope* of ASC 606. A financial institution may receive a fee for providing a guarantee of a loan. These types of financial guarantees are generally within the scope of ASC 460 or ASC 815. FASB TRG members generally agreed that an entity should look to ASC 460 or ASC 815 to determine the appropriate accounting for these fees. This is because ASC 606 contains a scope exception for contracts that fall under those topics, which provide principles an entity can follow to determine the appropriate accounting to reflect the financial guarantor's release from risk (and credit to earnings).

FASB TRG members generally agreed that fees from deposit-related services *are in the scope* of ASC 606. In contrast to the decisions for servicing income and financial guarantees, the guidance in ASC 405 that financial institutions apply to determine the appropriate liability accounting for customer deposits, does not provide a model for recognizing fees related to customer deposits (e.g., ATM fees, account maintenance or dormancy fees). Accordingly, FASB TRG members generally agreed that deposit fees and charges are in the scope of ASC 606, even though ASC 405 is listed as a scope exception in the standard, because of the lack of guidance on the accounting for these fees in ASC 405.

Question 2-4 **Are credit card fees in the scope of the new revenue standard?** [13 July 2015 TRG meeting; agenda paper no. 36]

A bank that issues credit cards can have various income streams (e.g., annual fees) from a cardholder under various credit card arrangements. Some of these fees may entitle cardholders to ancillary services (e.g., concierge services, airport lounge access). The card issuer also may provide rewards to cardholders based on their purchases. Stakeholders had questioned whether such fees and programs are within the scope of the new revenue standard, particularly when a good or service is provided to a cardholder.

FASB TRG members generally agreed that credit card fees that are accounted for under ASC 310 are not in the scope of ASC 606. This includes annual fees that may entitle cardholders to ancillary services. FASB TRG members noted that this conclusion is consistent with legacy accounting for credit card fees. However, the SEC Observer noted and FASB TRG members agreed that the nature of the arrangement must be truly that of a credit card lending arrangement in order to be in the scope of ASC 310, and entities will need to continue to evaluate their arrangements as they develop new types of programs.

While this question was raised by US GAAP stakeholders, IASB TRG members generally agreed that an IFRS entity would first need to determine whether the credit card fees are in the scope of IFRS 9 or IAS 39, which requires that any fees that are an integral part of the effective interest rate for a financial instrument be treated as an adjustment to the effective interest rate. Conversely, any fees that are not an integral part of the effective interest rate of the financial instrument generally will be accounted for under IFRS 15. As such, credit card fees could be treated differently under US GAAP and IFRS.

Question 2-5 **Are credit card holder rewards programs in the scope of the new revenue standard?** [13 July 2015 TRG meeting; agenda paper no. 36]

FASB TRG members generally agreed that if all consideration (i.e., credit card fees discussed in Question 2-4 above) related to the rewards program are determined to be in the scope of ASC 310, the rewards program would not be in the scope of ASC 606. However, this determination would have to be made based on the facts and circumstances due to the wide variety of credit card reward programs offered. IASB TRG members did not discuss this issue because the question was raised only in the context of US GAAP.

Question 2-6 **Are contributions in the scope of the new revenue standard?** [30 March 2015 TRG meeting; agenda paper no. 26]

Not-for-profit entities follow ASC 958-605 under legacy GAAP to account for contributions received (i.e., unconditional promises of cash or other assets in voluntary nonreciprocal transfers). Contributions are not explicitly excluded from the scope of the new standard. However, ASC 958-605 will not be wholly superseded by ASC 606.

FASB TRG members generally agreed that contributions are not within the scope of ASC 606 because they are nonreciprocal transfers. That is, contributions are generally not given in exchange for goods or services that are an output of the entity's ordinary activities. IASB TRG members did not discuss this issue because the question was raised only in the context of US GAAP.

Question 2-7 **Are fixed-odds wagering contracts in the scope of the new revenue standard?** [9 November 2015 TRG meeting; agenda paper no. 47]

US GAAP gaming entities account for earnings from fixed-odds wagering contracts as gaming revenue under ASC 924-605 in legacy GAAP. This guidance will be superseded by ASC 606. In fixed-odds wagering contracts, the payout for wagers placed on gaming activities (e.g., table games, slot machines, sports betting) is known at the time the wager is placed. US GAAP stakeholders had questioned whether these contracts are in the scope of the new revenue standard or whether they could meet the definition of a derivative and be in the scope of ASC 815.

FASB TRG members generally agreed that it was not clear whether fixed-odds wagering contracts should be in the scope of the new revenue standard or ASC 815. ASC 606 scopes in all contracts with customers unless the contracts are in the scope of other existing guidance, such as ASC 815. FASB TRG members agreed that it was possible that fixed–odds wagering contracts would meet the definition of a derivative under ASC 815 and therefore be scoped out of ASC 606. If the FASB believes that these contracts should be considered revenue arrangements and should be accounted for under ASC 606 once the industry-specific guidance is superseded, FASB TRG members recommended that a clarification be codified in US GAAP.

UPDATE: In May 2016, the FASB proposed including a scope exception in ASC 815 and ASC 924 that would clarify that these arrangements are within the scope of ASC 606. Comments were due 2 July 2016. To finalize this change, the FASB will need to issue a final ASU.

IASB TRG members did not discuss this issue because the question was raised only in the context of US GAAP. Under IFRS, consistent with a July 2007 IFRS Interpretations Committee agenda decision, wagers that meet the definition of a derivative are within the scope of IFRS 9 or IAS 39, and those that do not meet the definition of a derivative are within the scope of IFRS 15.

3 Identify the contract with the customer

To apply the model, an entity must first identify the contract, or contracts, to provide goods and services to customers as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying the Contract

606-10-25-2

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices. For example, if an entity has an established practice of starting performance based on oral agreements with its customers, it may determine that such oral agreements meet the definition of a contract.

In the Basis for Conclusions of ASU 2014-09,[18] the FASB acknowledged that entities will need to look at the relevant legal framework to determine whether the contract is enforceable because factors that determine enforceability may differ by jurisdiction. As a result, an entity may have to account for an arrangement as soon as performance begins rather than delay revenue recognition until the arrangement is documented in a signed contract, as is often the case under legacy GAAP. However, certain arrangements may require a written contract to comply with laws or regulations in a particular jurisdiction, and these requirements should be considered in determining whether a contract exists. The Board also clarified that while the contract must be legally enforceable to be within the scope of the model in the standard, all of the promises don't have to be enforceable to be considered performance obligations (see Section 4.1). That is, a performance obligation can be based on the customer's reasonable expectations (e.g., due to the entity's business practice of providing an additional good or service that isn't specified in the contract).

Illustration 3-1: Oral contract

IT Support Co. provides online technology support for consumers remotely via the internet. For a flat fee, IT Support Co. will scan a customer's personal computer (PC) for viruses, optimize the PC's performance and solve any connectivity problems. When a customer calls to obtain the scan services, IT Support Co. describes the services it can provide and states the price for those services. When the customer agrees to the terms stated by the representative, payment is made over the telephone. IT Support Co. then gives the customer the information needed to obtain the scan services (e.g., an access code for the website) and provides the services when the customer connects to the internet and logs on to the entity's website (which may be that day or a future date).

[18] Paragraph BC32 of ASU 2014-09.

In this example, IT Support Co. and its customer are entering into an oral agreement, which is legally enforceable in this jurisdiction, for IT Support Co. to repair the customer's PC and for the customer to provide consideration by transmitting a valid credit card number and authorization over the telephone. The required criteria (discussed further in ASC 606-10-25-1 below) are all met, and this agreement will be within the scope of the model in the standard, even if the entity has not yet performed the scan services.

3.1 Attributes of a contract

To help entities determine whether (and when) their arrangements with customers are contracts within the scope of the model in the standard, the Board identified certain criteria that must be met. The FASB noted in the Basis for Conclusions of ASU 2014-09[19] that the criteria are similar to those in legacy GAAP's revenue recognition guidance and in other existing standards and are important in an entity's assessment of whether the arrangement contains enforceable rights and obligations.

The criteria are as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying the Contract

606-10-25-1

An entity shall account for a **contract** with a **customer** that is within the scope of this Topic only when all of the following criteria are met:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

b. The entity can identify each party's rights regarding the goods or services to be transferred.

c. The entity can identify the payment terms for the goods or services to be transferred.

d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).

606-10-25-5

If a contract with a customer meets the criteria in paragraph 606-10-25-1 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C).

[19] Paragraph BC33 of ASU 2014-09.

These criteria are assessed at the inception of the arrangement. If the criteria are met at that time, an entity does not reassess the criteria unless there is an indication of a significant change in facts and circumstances. For example, as noted in ASC 606-10-25-5, if the customer's ability to pay significantly deteriorates, an entity would have to reassess whether it is probable that the entity will collect the consideration to which it is entitled in exchange for transferring the remaining goods and services under the contract. The updated assessment is prospective in nature and would not change the conclusions associated with goods and services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognized under the contract.[20]

If the criteria are not met, the arrangement should not be considered a revenue contract under the standard, and the guidance discussed in Section 3.5 should be applied.

3.1.1 Parties have approved the contract and are committed to perform their respective obligations

As indicated in the Basis for Conclusions of ASU 2014-09,[21] the Board included this criterion because a contract might not be legally enforceable without approval of both parties. Further, the Board decided that the form of the contract (i.e., oral, written or implied) is not determinative in assessing whether the parties have approved the contract. Instead, an entity must consider all relevant facts and circumstances when assessing whether the parties intend to be bound by the terms and conditions of the contract. In some cases, the parties to an oral or implied contract may have the intent to fulfill their respective obligations while, in other cases, a written contract may be required before an entity can conclude that the parties have approved the arrangement.

In addition to approving the contract, the entity must also be able to conclude that both parties are committed to perform their respective obligations. That is, the entity must be committed to providing the promised goods and services, and the customer must be committed to purchasing those promised goods and services. In the Basis for Conclusions of ASU 2014-09,[22] the Board clarified that an entity and a customer do not always have to be committed to fulfilling all of their respective rights and obligations for a contract to meet this requirement. The Board cited as an example a supply agreement between two parties with stated minimums under which the customer does not always buy the required minimum amount and the entity does not always enforce its right to make the customer make those minimum purchases. In this situation, the Board said that it may still be possible for the entity to demonstrate there is sufficient evidence to conclude that the parties are substantially committed to the contract. This criterion does not address a customer's intent and ability to pay the consideration (i.e., collectibility). Collectibility is a separate criterion and is discussed in Section 3.1.5.

Termination clauses are also an important consideration when determining whether both parties are committed to perform under a contract and, consequently, whether a contract exists. See Section 3.2 for further discussion of termination clauses and how they affect contract duration.

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[20] Paragraph BC34 of ASU 2014-09.
[21] Paragraph BC35 of ASU 2014-09.
[22] Paragraph BC36 of ASU 2014-09.

3.1.2 Each party's rights regarding the goods or services to be transferred can be identified

This criterion is relatively straightforward. If the goods and services to be provided in the arrangement cannot be identified, it is not possible to conclude that an entity has a contract within the scope of the model in the standard. The Board indicated[23] that if the promised goods and services cannot be identified, the entity can't assess whether those goods and services have been transferred because the entity would be unable to assess each party's rights with respect to those goods and services.

3.1.3 Payment terms can be identified for the goods or services to be transferred

Identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. Provided there will be an enforceable right to payment (i.e., enforceability as a matter of law) and the contract contains sufficient information to enable the entity to estimate the transaction price (see further discussion on estimating the transaction price in Chapter 5), the contract would qualify for accounting under the model (assuming the remaining criteria in ASC 606-10-25-1 have been met).

3.1.4 Commercial substance

The Board explained in the Basis for Conclusions of ASU 2014-09[24] that it included a criterion requiring a contract to have commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract) to prevent entities from artificially inflating revenue. An arrangement that does not have commercial substance should not be accounted for under the standard. Historically, some entities in high-growth industries engaged in round-tripping transactions in which goods and services were transferred back and forth between the same entities in an attempt to show higher transaction volume and higher gross revenue. This is also a risk in arrangements involving nonmonetary consideration. Determining whether an arrangement has commercial substance for purposes of the revenue standard is consistent with the commercial substance determination elsewhere in US GAAP, such as in the nonmonetary transactions guidance in ASC 845. This determination may require significant judgment. In all situations, the entity should be able to demonstrate a substantive business purpose for the nature and structure of its transactions.

In a change from legacy guidance, the standard does not contain prescriptive guidance for advertising barter transactions. We anticipate entities will need to carefully consider the "commercial substance" criterion when evaluating these types of transactions to make sure that they have commercial substance.

3.1.5 Collectibility

FASB amendments

In May 2016, the FASB issued ASU 2016-12 that amended the collectibility guidance to clarify that the objective of the collectibility threshold is to determine whether the contract is valid and represents a substantive transaction. It also clarified that this determination is based on whether a customer has the ability and intention to pay the promised consideration in exchange for the goods and services that *will* be transferred to the customer. In making this assessment, an entity will evaluate its exposure to credit risk for those goods and services that will be transferred to the customer. That is, in some circumstances, an entity may not need to assess its ability to collect all of the consideration in the contract.

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[23] Paragraph BC37 of ASU 2014-09.
[24] Paragraph BC40 of ASU 2014-09.

Under the revenue standard, collectibility refers to the customer's ability and intent to pay substantially all of the amount of consideration to which the entity will be entitled in exchange for the goods and services that will be transferred to the customer. An entity should assess a customer's ability to pay based on the customer's financial capacity and its intention to pay considering all relevant facts and circumstances, including past experiences with that customer or customer class.

The standard describes the collectibility assessment as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Assessing Collectibility

606-10-55-3A

Paragraph 606-10-25-1(e) requires an entity to assess whether it is **probable** that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the **customer.** The assessment, which is part of identifying whether there is a **contract** with a customer, is based on whether the customer has the ability and intention to pay the consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer. The objective of this assessment is to evaluate whether there is a substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue model in this Topic.

As noted in the Basis for Conclusions of ASU 2014-09,[25] the purpose of the criteria in ASC 606-10-25-1 is to require an entity to assess whether a contract, as defined by the standard, exists and represents a valid transaction. The collectibility criterion (i.e., determining whether the customer has the ability and the intention to pay substantially all of the promised consideration) is a key part of that assessment. As stated in the Basis for Conclusions of ASU 2016-12,[26] if it is not probable that the customer will pay (i.e., fulfill its obligations under the contract), there is a question about whether the contract is valid and the revenue-generating transaction is substantive, regardless of whether a legal contract exists. However, the Board also noted[27] that entities generally only enter into contracts after concluding it is probable that they will be fairly compensated for their performance. That is, in most instances, an entity would not enter into a contract with a customer if there was significant credit risk associated with that customer without also having adequate economic protection to ensure that it would collect the consideration. Therefore, the Board expects many arrangements will not fail to meet the collectibility criterion.

The new standard requires an entity to evaluate at contract inception (and when significant facts and circumstances change) whether it is *probable* that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer. This threshold is similar to the one in legacy GAAP guidance. Under legacy guidance, revenue recognition is permitted only when collectibility is reasonably assured (assuming other basic revenue recognition criteria have been met). For purposes of this analysis, the term "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. If it is not probable that the entity will collect amounts to which it is entitled, the contract should not be accounted for under the revenue model until the concerns about collectibility have been resolved (see Section 3.5 for further discussion).

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[25] Paragraph BC43 of ASU 2014-09.

[26] Paragraphs BC12 and BC14 of ASU 2016-12.

[27] Paragraph BC43 of ASU 2014-09 and BC10 of ASU 2016-12.

As noted in the Basis for Conclusions of ASU 2016-12,[28] the Board used the term "substantially all" because a contract may represent a substantive transaction, even if it is not probable the entity will collect 100% of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. That is, the entity can determine that it is probable that it will collect something short of 100% of the consideration, as long as that amount is substantially all of the consideration, and still have a substantive transaction.

The standard includes the following implementation guidance on how to apply the collectibility criterion:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Assessing Collectibility

606-10-55-3B

The collectibility assessment in paragraph 606-10-25-1(e) is partly a forward-looking assessment. It requires an entity to use judgment and consider all of the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity expects to transfer to the customer. The assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

606-10-55-3C

When assessing whether a contract meets the criterion in paragraph 606-10-25-1(e), an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

a. Payment terms — In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.

b. The ability to stop transferring promised goods or services — An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due. In those cases, an entity should assess only the collectibility of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer on the basis of the entity's rights and customary business practices. Therefore, if the customer fails to perform as promised and, consequently, the entity would respond to the customer's failure to perform by not transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.

An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

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[28] Paragraph BC12 of ASU 2016-12.

An entity should consider the probability of collecting substantially all of the consideration to which it will be entitled in exchange for the goods or services that *will* be transferred to the customer rather than the total amount promised for all goods or services in the contract. That is, if the customer were to fail to perform as promised and the entity would stop transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the goods or services that would not be transferred. The entity in this case would need to have the right to stop transferring goods or services when the customer fails to pay.

The Board noted in the Basis for Conclusions of ASU 2016-12[29] that an entity would evaluate the goods or services that it expects will be transferred based on the customary business practices of the entity in dealing with its exposure to the customer's credit risk throughout the contract. This assessment requires the entity to consider the relative position of the entity's contractual rights to the consideration and the entity's performance obligations, in addition to evaluating a customer's credit and payment history. For example, the entity could stop providing goods or services to the customer (provided it has the right to do so) or could require advance payments to mitigate its credit risk. When an entity stops providing goods or services to the customer, it mitigates its credit risk on the consideration for those additional goods and services. Consideration paid in advance of the goods and services being delivered is no longer subject to credit risk.

The standard specifically precludes an entity from evaluating its ability to repossess an asset as part of the collectibility assessment. The FASB noted in the Basis for Conclusions of ASU 2016-12[30] that the ability to repossess an asset does not mitigate an entity's exposure to credit risk for the consideration promised in the contract. However, that ability may affect the entity's assessment of whether it has transferred control of the asset to the customer.

The following example from the standard illustrates when an entity may conclude that a contract meets the collectibility criterion because the entity would respond to the customer's failure to pay by not transferring any additional goods or services to the customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 1 — Collectibility of the Consideration

Case B — Credit Risk is Mitigated

606-10-55-98A

An entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month.

606-10-55-98B

The transaction price of the contract is $720, and $20 is due at the end of each month. The standalone selling price of the monthly service is $20. Both parties are subject to termination penalties if the contract is cancelled.

606-10-55-98C

The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of $720, the customer is expected to make the payments required under the contract for at least 9 months. If, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and to pursue collection for the unpaid services.

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[29] Paragraph BC11 of ASU 2016-12.

[30] Paragraph BC15 of ASU 2016-12.

606-10-55-98D

In assessing whether the contract meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer in accordance with paragraph 606-10-55-3B and its business practice of stopping service in response to customer nonpayment in accordance with paragraph 606-10-55-3C. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

606-10-55-98E

It is not probable that the entity will collect the entire transaction price ($720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided). Consequently, assuming the criteria in paragraph 606-10-25-1(a) through (d) are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess the criteria in paragraph 606-10-25-1 if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

In contrast to the previous example, the following example illustrates when an entity may conclude that a contract does not meet the collectibility criterion because there is substantial risk that the entity would not receive any payment for services provided, even when the entity would respond to the customer's failure to pay by not transferring any additional goods or services to the customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 1 — Collectibility of the Consideration

Case C — Credit Risk is Not Mitigated

606-10-55-98F

The same facts as in Case B apply to Case C, except that the entity's history with this class of customer indicates that there is a risk that the customer will not pay substantially all of the consideration for services received from the entity, including the risk that the entity will never receive any payment for any services provided.

606-10-55-98G

In assessing whether the contract with the customer meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to the customer's nonpayment in accordance with paragraph 606-10-55-3C.

606-10-55-98H

At contract inception, the entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the services that will be transferred to the customer. The entity concludes that not only is there a risk that the customer will not pay for services received from the entity, but also there is a risk that the entity will never receive any payment for any services provided. Subsequently, when the customer initially pays for one month of service, the entity accounts for the consideration received in accordance with paragraphs 606-10-25-7 through 25-8. The entity concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract, and the entity is continuing to provide services to the customer.

606-10-55-98I

Assume that the customer has made timely payments for several months. In accordance with paragraph 606-10-25-6, the entity assesses the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met. In making that evaluation, the entity considers, among other things, its experience with this specific customer. On the basis of the customer's performance under the contract, the entity concludes that the criteria in 606-10-25-1 have been met, including the collectibility criterion in paragraph 606-10-25-1(e). Once the criteria in paragraph 606-10-25-1 are met, the entity applies the remaining guidance in this Topic to recognize revenue.

The amount of consideration that is assessed for collectibility is the amount to which the entity expects to be entitled, which under the standard is the transaction price for the goods or services that will be transferred to the customer rather than the stated contract price for those items. Entities will need to first determine the transaction price before assessing the collectibility of that amount. The contract price and transaction price most often will differ because of variable consideration (e.g., rebates, discounts or explicit or implicit price concessions) that reduces the amount of consideration stated in the contract. For example, the transaction price for the items expected to be transferred may be less than the stated contract price for those items if an entity concludes that it has offered or is willing to accept a price concession on products sold to a customer as a means to assist the customer in selling those items through to end consumers. As discussed in Section 5.2.1.1, an entity will deduct from the contract price any variable consideration that would reduce the amount of consideration an entity expects to be entitled to (e.g., the estimated price concession) at contract inception to derive the transaction price for those items.

How we see it

Although the overall notion of collectibility in the standard is similar to the collectibility requirement in SAB Topic 13, applying the concept to a portion of the contractual amount instead of the total contract price is a significant change. SAB Topic 13 requires that the entire contract price must be reasonably assured before an entity can recognize any revenue on the arrangement. This difference could result in the earlier recognition of revenue for a contract in which a portion of the contract price is considered to be at risk, but not the entire amount.

Significant judgment will be required to determine when an expected partial payment indicates that (1) there is an implied price concession in the contract, (2) there is an impairment loss or (3) the arrangement lacks sufficient substance to be considered a contract under the standard. See Section 5.2.1.1 for further discussion on implicit price concessions.

IASB differences

IFRS 15 also uses the term "probable" for the collectibility assessment, which means "more likely than not" under IFRS. That is a lower threshold than "probable" under US GAAP.

IFRS 15 does not include the implementation guidance in ASC 606-10-55-3A through 55-3C. However, the IASB stated in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that it does not expect differences in outcomes in relation to the evaluation of the collectibility criterion.

Question 3-1 **How should an entity assess collectibility for a portfolio of contracts?** [26 January 2015 TRG meeting; agenda paper no. 13]

TRG members generally agreed that if an entity has determined it is probable that a customer will pay amounts owed under a contract, but the entity has historical experience that it will not collect consideration from some customers within a portfolio of contracts (see Section 3.3.1), it would be appropriate for the entity to record revenue for the contract in full and separately evaluate the corresponding contract asset or receivable for impairment. That is, the entity would not conclude the arrangement contains an implicit price concession and would not reduce revenue for the uncollectible amounts. See Section 5.2.1.1 for a discussion of evaluating whether an entity has offered an implicit price concession.

Consider the following example included in the TRG agenda paper: An entity has a large volume of similar customer contracts for which billings are done in arrears on a monthly basis. Before accepting a customer, the entity performs procedures designed to determine that it is probable that the customer will pay the amounts owed and it does not accept customers if it is not probable that the customer will pay the amounts owed. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that it will have some customers that will not pay all amounts owed. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 98% of the amounts billed. In this case, the entity would recognize revenue for the full amount due and recognize bad debt expense for the 2% of the amount due that the entity does not expect to collect.

In this example, the entity concludes that collectibility is probable for each customer based on its procedures performed prior to accepting each customer and on its historical experience with this customer class while also accepting that there is some credit risk inherent with this customer class. Further, the entity concludes that any amounts not collected do not represent implied price concessions and instead are due to general credit risk that was present in a limited number of customer contracts. Some TRG members cautioned that the analysis to determine when to record bad debt expense for a contract in the same period when revenue is recognized (instead of reducing revenue for an anticipated price concession) will require judgment.

Question 3-2 **When should an entity reassess collectibility?** [26 January 2015 TRG meeting; agenda paper no. 13]

The standard requires an entity to reassess whether it is probable that it will collect the consideration to which it will be entitled when significant facts and circumstances change. Example 4 in the standard illustrates a situation in which a customer's financial condition declines and its current access to credit and available cash on hand is limited. In this case, the entity does not reassess the collectibility criterion. However, in a subsequent year, the customer's financial condition further declines after losing access to credit and its major customers. The example illustrates that this subsequent change in the customer's financial condition is so significant that a reassessment of the criteria for identifying a contract is required, resulting in the collectibility criterion not being met. The TRG agenda paper says that this example illustrates that it was not the Board's intent to require an entity to reassess collectibility when changes occur that are relatively minor in nature (i.e., those that do not call into question the validity of the contract). TRG members generally agreed that entities would need to exercise judgment to determine whether changes in the facts and circumstances are significant enough to indicate that a contract no longer exists.

3.2 Contract enforceability and termination clauses

An entity will have to first determine the term of the contract to apply certain aspects of the revenue model (e.g., identifying performance obligations, determining the transaction price). The contract term to be evaluated is the period in which parties to the contract have present enforceable rights and obligations, as described in the standard:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying the Contract

606-10-25-3

Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

606-10-25-4

For the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

a. The entity has not yet transferred any promised goods or services to the customer.

b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

The period in which enforceable rights and obligations exist may be affected by termination provisions in the contract. For example, an entity may apply the standard to only a portion of a contract with a stated term when the contract allows either party to terminate it at any time without penalty. Significant judgment will be required to determine the effect of termination provisions on the contract term. The contract term to which the standard is applied may affect the number of performance obligations identified and the determination of the transaction price. It may also affect the amounts disclosed in some of the required disclosures.

When evaluating collectibility and whether a valid contract exists, ASC 606-10-25-3 states that an entity should apply the guidance to the portion of the goods or services that will be transferred to the customer (as discussed in Section 3.1.5). This collectibility guidance should not affect the contract term an entity considers when applying the rest of the model (e.g., when determining or allocating the transaction price).

If each party has the unilateral right to terminate a "wholly unperformed" contract without compensating the counterparty, the standard states that, for purposes of the standard, a contract does not exist, and its accounting and disclosure requirements would not apply. This is because the contracts would not affect an entity's financial position or performance until either party performs. Any arrangement in which the vendor has not provided any of the contracted goods or services and has not received or is not entitled to receive any of the contracted consideration is considered to be a "wholly unperformed" contract.

The guidance on "wholly unperformed" contracts does not apply if the parties to the contract have to compensate the other party if they exercise their right to terminate the contract and that termination payment is considered substantive. Significant judgment will be required to determine whether a termination payment is substantive, and all facts and circumstances related to the contract should be considered.

How we see it

Evaluating termination provisions will be a change from legacy GAAP, in which entities apply the revenue guidance for the stated term of the contract and generally only account for terminations when they occur. Under the new standard, entities may be required to account for contracts with stated terms as month-to-month (or possibly shorter duration) contracts if the parties to the contracts can terminate them without penalty.

Question 3-3

How do termination clauses and termination payments affect the duration of a contract (i.e., the contractual period)? [31 October 2014 TRG meeting; agenda paper no. 10]

Entities will need to carefully evaluate termination clauses and any related termination payments to determine how they affect contract duration (i.e., the period in which there are enforceable rights and obligations). TRG members generally agreed that enforceable rights and obligations exist throughout the term in which each party has the unilateral enforceable right to terminate the contract by compensating the other party. For example, if a contract includes a substantive termination payment, the duration of the contract should equal the term through which a termination penalty would be due (which could be the stated contractual term or a shorter duration if the termination penalty did not extend to the end of the contract). However, TRG members observed that the determination of whether a termination penalty is substantive, and what the enforceable rights and obligations are under a contract, will require judgment and consideration of the facts and circumstances.

TRG members also agreed that when a contract with a stated contractual term can be terminated by either party for no consideration at any time, the contract term ends when control of the goods or services already provided transfers to the customer (e.g., a month-to-month service contract), regardless of its stated contractual term. Entities will need to consider whether a contract includes a notification or cancellation period (e.g., the contract can be terminated with 90 days' notice) that would cause the contract term to extend beyond the date when control of the goods or services already provided transferred to the customer. In these cases, the contract term would be shorter than the stated contractual term but would extend beyond the date when control of the goods or services already provided transferred to the customer.

Question 3-4

How do termination clauses that provide only the customer with the right to cancel the contract affect the duration of the contract, and how do termination penalties affect this conclusion? [9 November 2015 TRG meeting; agenda paper no. 48]

Enforceable rights and obligations exist throughout the term in which each party has the unilateral enforceable right to terminate the contract by compensating the other party. Members of the TRG do not view a customer-only right to terminate sufficient to warrant a different conclusion than one in which both parties have the right to terminate, as discussed in Question 3-3.

TRG members generally agreed that a substantive termination penalty payable by a customer to the entity is evidence of enforceable rights and obligations of both parties throughout the period covered by the termination penalty. For example, in a four-year service contract in which the customer has the right to cancel without cause at the end of each year but would incur a termination penalty that decreases each year (and is determined to be substantive), TRG members generally agreed that the arrangement should be treated as a four-year contract.

TRG members also discussed situations when a contractual penalty would result in including optional goods or services in the accounting for the original contract (see Question 4-13 in Section 4.6).

TRG members observed that the determinations of whether a termination penalty is substantive, and what the enforceable rights and obligations are under a contract, will require judgment and consideration of the facts and circumstances.

If enforceable rights and obligations do not exist throughout the entire term stated in the contract (e.g., if there are no (or non-substantive) contractual penalties that compensate the entity upon cancellation, when the customer has the unilateral right to terminate the contract for reasons other than cause or contingent events outside the customer's control), TRG members generally agreed that customer cancellation rights would be treated as customer options. The Board noted in the Basis for Conclusions of ASU 2014-09[31] that a cancellation option or termination right can be similar to a renewal option. An entity would then need to determine whether the cancellation option indicates that the customer has a material right that would need to be accounted for as a performance obligation (e.g., there is a discount for goods or services provided during the cancellable period that provides the customer with a material right).

Question 3-5 **Do termination payments that an entity has a past practice of not enforcing affect the duration of the contract?** [31 October 2014 TRG meeting; agenda paper no. 10]

The TRG agenda paper noted that the evaluation of the termination payment in determining the duration of a contract depends on whether the past practice is considered by law (which may vary by jurisdiction) to limit the parties' enforceable rights and obligations. An entity's past practice of allowing customers to terminate the contract early without enforcing collection of the termination payment affects the contract term only in cases in which the parties' legally enforceable rights and obligations are limited because of the lack of enforcement by the entity. If that past practice does not change the parties' legally enforceable rights and obligations, the contract term should equal the term through which a substantive termination penalty would be due (which could be the stated contractual term or a shorter duration if the termination penalty did not extend to the end of the contract).

Question 3-6 **How should an entity account for a partial termination of a contract (e.g., a change in the contract term from 3 years to 2 years prior to the beginning of year 2)?**

We believe an entity should account for the partial termination of a contract as a contract modification (see Section 3.4) because it results in a change in the scope of the contract. ASC 606-10-25-10 states that "a contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract." A partial termination of a contract results in a change to the enforceable rights and obligations in the existing contract. This conclusion is consistent with TRG agenda paper no. 48,[32] which stated, "a substantive termination penalty is evidence of enforceable rights and obligations throughout the contract term. The termination penalty is ignored until the contract is terminated at which point it will be accounted for as a modification." Consider the following example:

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[31] Paragraph BC391 of ASU 2014-09.

[32] 9 November 2015 TRG meeting; agenda paper no. 48.

An entity enters into a contract with a customer to provide monthly maintenance services for three years at a fixed price of $500 per month (i.e., total consideration of $18,000). The contract includes a termination clause that allows the customer to cancel the third year of the contract by paying a termination penalty of $1,000 (which is considered substantive for purposes of this example). The penalty would effectively result in an adjusted price per month for two years of $542 (i.e., total consideration of $13,000). At the end of the first year, the customer decides to cancel the third year of the contract and pays the $1,000 termination penalty specified in the contract.

In this example, the modification would not be accounted for as a separate contract because it does not result in the addition of distinct goods or services (see Section 3.4.2). Since the remaining services are distinct, the entity would apply the guidance in ASC 606-10-25-13(a) and account for the modification prospectively. The remaining consideration of $7,000 ($6,000 under the original contract for the second year, plus the $1,000 payment upon modification) would be recognized over the remaining revised contract period of one year. That is, the entity would recognize the $1,000 termination penalty over the remaining performance period.

3.3 Combining contracts

In most cases, entities will apply the model to individual contracts with a customer. However, the standard *requires* entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet one or more of the criteria indicated below:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Combination of Contracts

606-10-25-9

An entity shall combine two or more **contracts** entered into at or near the same time with the same **customer** (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

a. The contracts are negotiated as a package with a single commercial objective.

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single **performance obligation** in accordance with paragraphs 606-10-25-14 through 25-22.

The Board explained in the Basis for Conclusions of ASU 2014-09[33] that it included the guidance on combining contracts in the standard because in some cases, the amount and timing of revenue might differ depending on whether an entity accounts for contracts as a single contract or separately.

Entities will need to apply judgment to determine whether contracts are entered into at or near the same time because the standard does not provide a bright line for making this assessment. The Board noted in the Basis for Conclusions of ASU 2014-09[34] that the longer the period between entering into different contracts, the more likely it is that the economic circumstances affecting the negotiations of those contracts will have changed.

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[33] Paragraph BC71 of ASU 2014-09.

[34] Paragraph BC75 of ASU 2014-09.

Negotiating multiple contracts at the same time is not sufficient evidence to demonstrate that the contracts represent a single arrangement for accounting purposes. In the Basis for Conclusions of ASU 2014-09,[35] the Board noted that there are pricing interdependencies between two or more contracts when either of the first two criteria (i.e., the contracts are negotiated with a single commercial objective or the price in one contract depends on the price or performance of the other contract) are met, so the amount of consideration allocated to the performance obligations in each contract might not faithfully depict the value of the goods or services transferred to the customer if those contracts were not combined. The Board also explained that it decided to include the third criterion (i.e., the goods or services in the contracts are a single performance obligation) to avoid any structuring opportunities that would effectively allow entities to bypass the guidance for identifying performance obligations.

How we see it

The requirement to combine contracts is generally consistent with the underlying principles in legacy GAAP. As a result, entities may reach conclusions about combining contracts that are similar to those they reach under legacy GAAP.

3.3.1 Portfolio approach practical expedient

Under the standard, the five-step model is applied to individual contracts with customers. However, the FASB recognized that there may be situations in which it may be more practical for an entity to combine contracts for purposes of revenue recognition rather than attempt to account for each contract separately. Specifically, the standard includes the following practical expedient:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Objectives

606-10-10-4

This guidance specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or **performance obligations**) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

In order to use the portfolio approach, an entity must reasonably expect the accounting result will not be materially different from the result of applying the guidance to the individual contracts. However, the FASB said in the Basis for Conclusions of ASU 2014-09[36] that it does not intend for an entity to quantitatively evaluate every possible outcome when concluding that the portfolio approach is not materially different. Instead, it indicated that an entity should be able to take a reasonable approach to determine the portfolios that would be representative of its types of customers, and that an entity should use judgment in selecting the size and composition of these portfolios.

How we see it

The application of the portfolio approach likely will vary based on the facts and circumstances of each entity. Management will need to determine whether to apply the portfolio approach to some or all of the entity's business lines. In addition, an entity may choose to apply the portfolio approach to only certain aspects of the new model (e.g., determining the transaction price in Step 3).

[35] Paragraph BC73 of ASU 2014-09.
[36] Paragraph BC69 of ASU 2014-09.

Question 3-7 **How should an entity assess collectibility for a portfolio of contracts?** [26 January 2015 TRG meeting; agenda paper no. 13]

See response to Question 3-1 in Section 3.1.5.

Question 3-8 **Can entities apply the portfolio approach practical expedient for the evaluation of and/or accounting for contracts costs under ASC 340-40?**

See response to Question 9-5 in Section 9.3.

3.4 Contract modifications

Parties to an arrangement frequently agree to modify the scope or price (or both) of their contract. If that happens, an entity must determine whether the modification should be accounted for as a new contract or as part of the existing contract. Generally, it is clear when a contract modification has taken place, but in some circumstances, that determination is more difficult. To assist entities with making this determination, the standard contains the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Contract Modifications

606-10-25-10

A contract modification is a change in the scope or price (or both) of a **contract** that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply the guidance in this Topic to the existing contract until the contract modification is approved.

606-10-25-11

A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the **transaction price** arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

The guidance above illustrates that the Board intended it to apply more broadly than to only finalized modifications. That is, this guidance says that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both). Instead of focusing on the finalization of a modified agreement, the guidance focuses on the enforceability of the changes to the rights and obligations in the contract. Once the entity determines the revised rights and obligations are enforceable, the entity should account for the contract modification.

The standard provides the following example to illustrate this point:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 9 — Unapproved Change in Scope and Price

606-10-55-134

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

606-10-55-135

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

Once an entity has determined that a contract has been modified, the entity has to determine the appropriate accounting for the modification. Certain modifications are treated as separate, standalone contracts, while others are combined with the original contract and accounted for in that manner. In addition, some modifications will be accounted for on a prospective basis and others on a cumulative catch-up basis. The Board developed different approaches to account for different types of modifications with an overall objective of faithfully depicting an entity's rights and obligations in each modified contract.[37] The standard includes the following guidance for determining the appropriate accounting approach:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Contract Modifications

606-10-25-12

An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).

[37] Paragraph BC76 of ASU 2014-09.

b. The price of the contract increases by an amount of consideration that reflects the entity's **standalone selling prices** of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

606-10-25-13

If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining **performance obligations** (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:

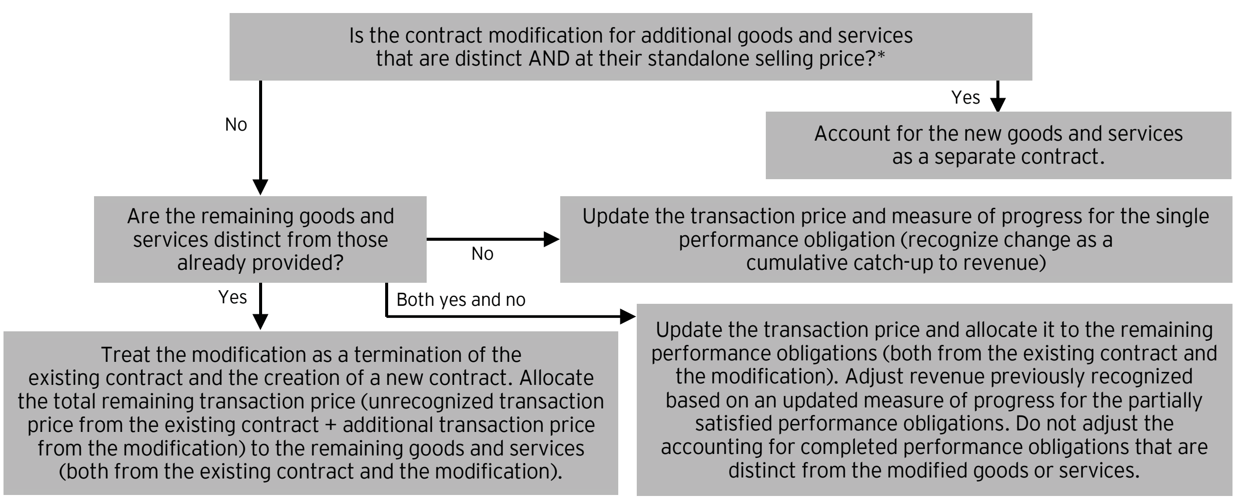
   1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as **revenue** and

   2. The consideration promised as part of the contract modification.

b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).

c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

The following chart illustrates this guidance:



* Under ASC 606-10-25-12, an entity may make appropriate adjustments to the standalone selling price to reflect the circumstances of the contract and still meet the criteria to account for the modification as a separate contract.

When assessing how to account for a contract modification, an entity must consider whether any additional goods or services are distinct, often giving careful consideration to whether those goods or services are distinct within the context of the modified contract (see Section 4.2.1 for further discussion on evaluating whether goods or services are distinct). That is, although a contract modification may add a new good or service that would be distinct in a standalone transaction, that new good or service may not be distinct when considered in the context of the contract, as modified. For example, in a building renovation project, a customer may request a contract modification to add a new room. The construction firm may commonly sell the construction of a room addition on a standalone basis, which would indicate that the service is capable of being distinct. However, when that service is added to an existing contract and the entity has already determined that the entire project is a single performance obligation, the added goods and services normally would be combined with the existing bundle of goods and services.

In contrast to the construction example for which the addition of otherwise distinct goods or services are combined with the existing single performance obligation and accounted for in that manner, a contract modification that adds distinct goods or services to a single performance obligation that is a series of distinct goods or services (see Section 4.2.2) is accounted for either as a separate contract or as the termination of the old contract and the creation of a new contract (i.e., prospectively). The Board explained in the Basis for Conclusions of ASU 2014-09[38] that it clarified the accounting for modifications that affect a single performance obligation that is made up of a series of distinct goods or services (e.g., repetitive service contracts) to address some stakeholders' concerns that an entity otherwise would have been required to account for these modifications on a cumulative catch-up basis.

How we see it

The requirement to determine whether to treat a change in contractual terms as a separate contract or a modification to an existing contract is similar to guidance for contract accounting in ASC 605-35. However, there is no guidance outside of ASC 605-35 in legacy GAAP that provides a general framework for accounting for contract modifications. Entities should evaluate whether their processes and controls for contract modifications will need to be updated for the new guidance.

Question 3-9 **When an arrangement that has already been determined to meet the standard's contract criteria is modified, should an entity reassess whether that arrangement still meets the criteria to be considered a contract within the scope of the model in the standard?**

There is no specific requirement in the standard to reconsider whether a contract meets the definition of a contract when it is modified. However, if a contract is modified, we believe that may indicate that "a significant change in facts and circumstances" has occurred (see Section 3.1) and that the entity should reassess the criteria in ASC 606-10-25-1 for the modified contract. Any reassessment is prospective in nature and would not change the conclusions associated with goods and services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognized under the contract because of the reassessment. However, due to the contract modification accounting (see Section 3.4.2), the entity may need to adjust contract assets or cumulative revenue recognized in the period of the contract modification.

Question 3-10 **How should an entity account for the exercise of a material right? That is, should it be accounted for as a contract modification, a continuation of the existing contract or as variable consideration?** [30 March 2015 TRG meeting; agenda paper no. 32]

See response to Question 4-16 in Section 4.6.

[38] Paragraph BC79 of ASU 2014-09.

Question 3-11 **How should entities account for modifications to licenses of intellectual property?**

See response to Question 8-1 in Section 8.1.4.

3.4.1 Contract modification represents a separate contract

Certain contract modifications are treated as separate, new contracts. For these modifications, the accounting for the original contract is not affected by the modification, and the revenue recognized to date on the original contract is not adjusted. Further, any performance obligations remaining under the original contract continue to be accounted for under the original contract. The accounting for this modification approach reflects the fact that there is no economic difference between a separate contract for additional goods and services and a modified contract for those same items, provided the two criteria required for this modification approach are met.

The first criterion that must be met for a modification to be treated as a separate contract is that the additional goods and services included in the modification must be distinct from the goods and services in the original contract. This assessment should be done in accordance with the standard's general requirements for determining whether promised goods and services are distinct (see Section 4.2.1). Only modifications that add distinct goods and services to the arrangement can be treated as separate contracts. Arrangements that reduce the amount of promised goods or services or change the scope of the original promised goods and services, by their very nature, cannot be considered separate contracts and have to be considered modifications of the original contracts (see Section 3.4.2).

The second criterion is that the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. In determining the standalone selling price, however, entities have some flexibility to adjust the selling price, depending on the facts and circumstances. For example, a vendor may give a current customer a discount on additional goods because the vendor would not incur selling-related costs that it typically incurs for new customers. In this example, the entity may determine that the additional transaction consideration meets this criterion, even though the discounted price is less than the standalone selling price of that good or service for a new customer. In another example, an entity may conclude that, with the additional purchases, the customer qualifies for a volume-based discount (see Questions 4-14 and 4-15 in Section 4.6 on volume discounts).

The following example illustrates a contract modification that represents a separate contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 5 — Modification of a Contract for Goods

606-10-55-111

An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case A — Additional Products for a Price That Reflects the Standalone Selling Price

606-10-55-112

When the contract is modified, the price of the contract modification for the additional 30 products is an additional $2,850 or $95 per product. The pricing for the additional products reflects the standalone selling price of the products at the time of the contract modification, and the additional products are distinct (in accordance with paragraph 606-10-25-19) from the original products.

606-10-55-113

In accordance with paragraph 606-10-25-12, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognizes revenue of $100 per product for the 120 products in the original contract and $95 per product for the 30 products in the new contract.

3.4.2 Contract modification is not a separate contract

In instances in which the criteria discussed in Section 3.4.1 are not met (i.e., distinct goods or services are not added or the distinct goods or services are not priced at their standalone selling price), contract modifications should be accounted for as changes to the original contract and not as separate contracts. This includes contract modifications that modify or remove previously agreed-upon goods and services or reduce the price of the contract. An entity would account for the effects of these modifications differently, depending on which one of the three scenarios described in ASC 606-10-25-13 most closely aligns with the facts and circumstances of the modification.

If the remaining goods and services after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract. For these modifications, the revenue recognized to date on the original contract (i.e., the amount associated with the completed performance obligations) is not adjusted. Instead, the remaining portion of the original contract and the modification are accounted for together on a prospective basis by allocating the remaining consideration (i.e., the unrecognized transaction price from the existing contract plus the additional transaction price from the modification) to the remaining performance obligations, including those added in the modification. This scenario is illustrated as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 5 — Modification of a Contract for Goods

606-10-55-111

An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case B — Additional Products for a Price That Does Not Reflect the Standalone Selling Price

606-10-55-114

During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of $80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of $15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of $900 ($15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is $1,500 or $50 per product. That price comprises the agreed-upon price for the additional 30 products of $2,400, or $80 per product, less the credit of $900.

606-10-55-115

At the time of modification, the entity recognizes the $900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of $80 per product does not reflect the standalone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 606-10-25-12 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity applies the guidance in paragraph 606-10-25-13(a) and accounts for the modification as a termination of the original contract and the creation of a new contract.

606-10-55-116

Consequently, the amount recognized as revenue for each of the remaining products is a blended price of $93.33 {[($100 × 60 products not yet transferred under the original contract) + ($80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.

In Example 5, Case B, the entity attributed a portion of the discount provided on the additional products to the previously delivered products because they contained minor defects. That portion of the discount was recognized as a reduction of the transaction price (and therefore revenue) on the date of the modification.

In similar situations, an entity will need to have sufficient evidence to indicate that a portion of the discount on the additional products specifically relates to the previously delivered products to make a similar conclusion. In many circumstances, this evidence may not exist so the discount will be attributed only to the additional products and recognized when control of those products transfers to the customer.

If the remaining goods and services to be provided after the contract modification are not distinct from those goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract. For these modifications, the entity will adjust revenue previously recognized, either up or down, to reflect the effect that the contract modification has on the transaction price and update the measure of progress (i.e., the revenue adjustment is made on a cumulative catch-up basis). This scenario is illustrated as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 8 — Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue

606-10-55-129

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of $1 million and a bonus of $200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 606-10-25-27(b) because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

Transaction price	$ 1,000,000
Expected costs	$ 700,000
Expected profit (30%)	$ 300,000

606-10-55-130

At contract inception, the entity excludes the $200,000 bonus from the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

606-10-55-131

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress toward complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 percent of its performance obligation on the basis of costs incurred to date ($420,000) relative to total expected costs ($700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, the cumulative revenue and costs recognized for the first year are as follows:

Revenue	$ 600,000
Costs	$ 420,000
Gross profit	$ 180,000

606-10-55-132

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by $150,000 and $120,000, respectively. Total potential consideration after the modification is $1,350,000 ($1,150,000 fixed consideration + $200,000 completion bonus). In addition, the allowable time for achieving the $200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized in accordance with paragraph 606-10-32-11 and includes the $200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 606-10-25-19(b) and concludes (on the basis of the factors in paragraph 606-10-25-21) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

606-10-55-133

Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 606-10-25-13(b)). The entity updates its measure of progress and estimates that it has satisfied 51.2 percent of its performance obligation ($420,000 actual costs incurred ÷ $820,000 total expected costs). The entity recognizes additional revenue of $91,200 [(51.2 percent complete × $1,350,000 modified transaction price) — $600,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

Finally, a change in a contract also may be treated as a combination of the two: a modification of the existing contract and the creation of a new contract. In this case, an entity would not adjust the accounting for completed performance obligations that are distinct from the modified goods or services. However, the entity would adjust revenue previously recognized, either up or down, to reflect the effect of the contract modification on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and update the measure of progress.

Question 3-12 **How should an entity account for a contract asset that exists when a contract is modified if the modification is treated as the termination of an existing contract and the creation of a new contract?** [18 April 2016 FASB TRG meeting; agenda paper no. 51]

See response to Question 10-5 in Section 10.1.

3.5 Arrangements that do not meet the definition of a contract under the standard

FASB amendments

In May 2016, the FASB issued ASU 2016-12 that added an additional event for when an entity can recognize revenue for consideration received from a customer when the arrangement does not meet the criteria to be accounted for as a revenue contract under the standard. Under this amendment, an entity should recognize revenue in the amount of nonrefundable consideration received when the entity has transferred control of the goods or services and has stopped transferring (and has no obligation to transfer) additional goods or services.

An arrangement that does not meet the criteria of a contract under the standard must be accounted for as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying the Contract

606-10-25-6

If a contract with a customer does not meet the criteria in paragraph 606-10-25-1, an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met.

606-10-25-7

When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as **revenue** only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

606-10-25-8

An entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 606-10-25-7 occurs or until the criteria in paragraph 606-10-25-1 are subsequently met (see paragraph 606-10-25-6). Depending on the facts and circumstances relating to the contract, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

Entities should continue to assess the criteria in ASC 606-10-25-1 (as discussed in Section 3.1) throughout the term of the arrangement to determine whether they are subsequently met. Once the criteria are met, the model in the standard would then apply, rather than the guidance discussed below.

In cases in which the contract does not meet those criteria (and continues not to meet them), an entity should recognize nonrefundable consideration received as revenue only when one of the following events has occurred:

- The entity has fully performed and substantially all of the consideration has been received
- The contract has been terminated
- The entity has transferred control of the goods or services and has stopped transferring (and has no obligation under the contract to transfer) additional goods or services to the customer, if applicable

Until one of these events happens, any consideration received from the customer is initially accounted for as a liability (not revenue), and the liability is measured at the amount of consideration received from the customer. The existing derecognition guidance in US GAAP should be applied to assets related to contracts that do not meet the criteria in paragraph 606-10-25-1. The Board noted[39] that whether these events have occurred does not have any effect on determining whether control of an asset has been transferred to a customer and, therefore, should not affect conclusions about when an asset should be derecognized. Once the buyer controls the asset (i.e., it has obtained control of the asset from the entity), the entity no longer controls that asset and should no longer recognize the asset. In the Basis for Conclusions of ASU 2014-09,[40] the Board indicated it intended this accounting to be similar to the "deposit method" that was previously included in US GAAP and applied when there was no consummation of a sale.

The Board decided[41] to include the guidance in ASC 606-10-25-7 to 25-8 to prevent entities from seeking alternative guidance or improperly analogizing to the revenue recognition guidance in circumstances in which an executed contract does not meet the criteria in ASC 606-10-25-1.

In the Basis for Conclusions of ASU 2016-12,[42] the Board noted that while some stakeholders did not support some of the accounting outcomes that result from the alternative recognition model described in ASC 606-10-25-7 to 25-8, it is the logical extension of the conclusion that a valid contract does not exist. That is, any cash received by the entity is deferred until either a contract exists under the standard or one of the events in ASC 606-10-25-7 occurs because if there is not a valid contract between the parties, there can be no assurance that consideration received from the customer is solely for past performance.

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[39] Paragraph BC28 of ASU 2016-12.
[40] Paragraph BC48 of ASU 2014-09.
[41] Paragraph BC47 of ASU 2014-09.
[42] Paragraph BC22 of ASU 2016-12.

The FASB further explained[43] that the third event is not the equivalent of legacy GAAP's "cash basis" of accounting under which an entity would recognize revenue as cash is received from the customer if collectibility was not considered reasonably assured at contract inception but the other three basic revenue recognition criteria were met.[44] Under the standard, an entity would only meet the requirements of this event if it has transferred control of the goods or services and has stopped transferring (and has no obligation under the contract to transfer) additional goods or services to the customer (which is not a requirement of legacy GAAP's "cash basis" accounting). This assessment will require judgment about the specific facts and circumstances (e.g., an entity's right to stop transferring goods or services may vary by arrangement or jurisdiction).

IASB differences

IFRS 15 does not contain the third event (i.e., the entity has transferred control of the goods or services and has stopped transferring, and has no obligation under the contract to transfer, additional goods or services to the customer) for when an entity can recognize revenue for consideration received from a customer when the arrangement does not meet the criteria to be accounted for as a revenue contract under the standard.

However, the IASB noted in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that contracts often specify that an entity has a right to terminate the contract in the event of non-payment and that this clause would not generally affect the entity's legal rights to recover any amounts due. Therefore, the IASB concluded that the guidance in IFRS 15 would allow an entity to conclude that a contract is terminated when it stops providing goods or services to the customer.

Question 3-13 **When is a contract considered terminated for purposes of applying ASC 606-10-25-7(b)?**

Determining whether a contract is terminated may require significant judgment and may require a legal assessment. The FASB noted in the Basis for Conclusions of ASU 2016-12[45] that an entity may pursue collection for a significant period of time after control of goods or services has transferred to the customer and not legally terminate the contract to maintain its legal rights to continue to pursue collection or its other legal rights under the contract. In these situations, nonrefundable consideration received from the customer could be recognized as a liability for a significant period of time during the period that an entity pursues collection, even though the entity may have stopped transferring goods or services to the customer and has no further obligations to transfer goods or services to the customer. The FASB included the event in ASC 606-10-25-7(c) to address these situations. In contrast, the IASB explained in the Basis for Conclusions on IFRS 15 when a contract is considered terminated under IFRS 15.

Question 3-14 **If an entity begins activities on a specifically anticipated contract either (1) before it agrees to the contract with the customer or (2) before the arrangement meets the criteria to be considered a contract under the standard, how should revenue be recognized at the date a contract exists?** [30 March 2015 TRG meeting; agenda paper no. 33]

See response to Question 7-8 in Section 7.1.4.3.

[43] Paragraph BC24 of ASU 2016-12.

[44] SAB Topic 13 requires that the following four basic criteria be met before revenue can be considered realized or earned: (1) persuasive evidence of the arrangement exists, (2) delivery has occurred or services have been rendered, (3) the seller's price to the buyer is fixed or determinable and (4) collectibility is reasonably assured.

[45] Paragraph BC23 of ASU 2016-12.

4 Identify the performance obligations in the contract

To apply the standard, an entity must identify the promised goods and services within the contract and determine which of those goods and services are separate performance obligations. The Board noted in the Basis for Conclusions of ASU 2014-09[46] that it developed the notion of a "performance obligation" to assist entities with appropriately identifying the unit of accounting for purposes of applying the standard. Because the standard requires entities to allocate the transaction price to performance obligations, identifying the correct unit of accounting is fundamental to recognizing revenue on a basis that faithfully depicts the entity's performance in transferring the promised goods or services to the customer.

The standard provides the following guidance with respect to identifying the performance obligations in a contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

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.

[46] Paragraph BC85 of ASU 2014-09.

4.1 Identifying the promised goods and services in the contract

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that amended the guidance on identifying performance obligations to allow entities to disregard promises deemed to be immaterial in the context of a contract. The FASB's intent is to allow entities to disregard immaterial items at the contract level and not require that these items be aggregated and assessed for materiality at the entity level.

As a first step in identifying the performance obligation(s) in the contract, the standard requires an entity to identify, at contract inception, the promised goods and services in the contract. However, unlike legacy guidance, which does not define the term "deliverable," the new standard provides guidance on the types of items that may be goods or services promised in the contract as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Identifying Performance Obligations

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 promised goods and services 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 reasonable expectation of the customer that the entity will transfer a good or service to the customer.

606-10-25-16A

An entity is not required to assess whether promised goods or services are **performance obligations** if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

606-10-25-16B

An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

606-10-25-17

Promised goods or services 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 promised goods or services in the contract with the customer.

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 55-60 and paragraphs 606-10-55-62 through 55-65B)

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).

In addition, the standard indicates that certain activities are not promised goods or services, such as activities that an entity must perform to satisfy its obligation to deliver the promised goods and services (e.g., internal administrative activities). After identifying the promised goods or services in the contract, an entity will then determine which of these promised goods or services (or bundle of goods and services) represent separate performance obligations. This evaluation is similar to the evaluation in legacy GAAP, which requires entities to identify the deliverables in an arrangement and then determine whether those deliverables should be combined into a unit of accounting.

In order for an entity to identify the promised goods and services in a contract, the standard says that an entity should consider whether the customer has a reasonable expectation that the entity will provide those goods or services. If the customer has a reasonable expectation that it will receive certain goods or services, it would likely view those promises as part of the negotiated exchange. This expectation will most commonly be created from an entity's explicit promises in a contract to transfer a good(s) or service(s) to the customer.

However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices or standard industry norms (i.e., outside of the written contract). As discussed in Chapter 3, the Board clarified[47] that while the contract must be legally enforceable to be within the scope of the revenue model, all of the promises (explicit or implicit) don't have to be enforceable to be considered when determining the entity's performance obligations. That is, a performance obligation can be based on a customer's reasonable expectations (e.g., due to the entity's business practice of providing an additional good or service that isn't specified in the contract).

[47] Paragraphs BC32 and BC87 of ASU 2014-09.

In addition, some items commonly considered to be marketing incentives or incidental goods or services under legacy GAAP will have to be evaluated under the standard to determine whether they represent promised goods and services in the contract. Such items may include "free" handsets provided by telecommunication entities; "free" maintenance provided by automotive manufacturers; and customer loyalty points awarded by supermarkets, airlines and hotels. [48] Although an entity might not consider those goods or services to be the "main" items the customer contracts to receive, the FASB concluded[49] that they are goods or services the customer pays for, and the entity should allocate consideration to them for purposes of revenue recognition.

ASC 606-10-25-18 provides examples of promised goods or services that may be included in a contract with a customer. Several of them are considered deliverables under legacy GAAP, including a good produced by an entity or a contractually agreed-upon task (or service) performed for a customer. However, the FASB also included other examples that may not be considered deliverables under legacy GAAP. For example, ASC 606-10-25-18(e) describes a stand-ready obligation as a promised service that consists of standing ready to provide goods or services or making goods or services available for a customer to use as and when it decides to use it. That is, a stand-ready obligation is the promise that the customer will have access to a good or service rather than a promise to transfer the underlying good or service itself. Stand-ready obligations are common in the software industry (e.g., unspecified updates to software on a when-and-if-available basis) and may be present in other industries. See Questions 4-2 and 4-3 below for further discussion on stand-ready obligations.

ASC 606-10-25-18(g) also notes that a promise to a customer may include granting rights to goods or services to be provided in the future that the customer can resell or provide to its customer if those rights existed at the time that the parties agreed to the contract. The FASB explained in the Basis for Conclusions of ASU 2014-09[50] that it thought it was important to clarify that a performance obligation may exist for a promise to provide a good or service in the future (e.g., when an entity makes a promise to provide goods or services to its customer's customer). These types of promises exist in distribution networks in various industries and are common in the automotive industry.

The standard includes the following example to illustrate how an entity should identify the promised goods and services in a contract (including both explicit and implicit promises). The example also evaluates whether the identified promises are performance obligations, which we discuss in Section 4.2:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 12 — Explicit and Implicit Promises in a Contract

606-10-55-151

An entity, a manufacturer, sells a product to a distributor (that is, its customer), who will then resell it to an end customer.

[48] Paragraph BC88 of ASU 2014-09.
[49] Paragraph BC89 of ASU 2014-09.
[50] Paragraph BC92 of ASU 2014-09.

Case A — Explicit Promise of Service

606-10-55-152

In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (that is, "free") to any party (that is, the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.

606-10-55-153

The contract with the customer includes two promised goods or services—(a) the product and (b) the maintenance services (because the promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor). The entity assesses whether each good or service is distinct in accordance with paragraph 606-10-25-19. The entity determines that both the product and the maintenance services meet the criterion in paragraph 606-10-25-19(a). The entity regularly sells the product on a standalone basis, which indicates that the customer can benefit from the product on its own. The customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (that is, the product).

606-10-55-153A

The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable (in accordance with paragraph 606-10-25-19(b)) on the basis of the principle and the factors in paragraph 606-10-25-21. The product and the maintenance services are not inputs to a combined item in this contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customize the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to satisfy each of the promises in the contract independent of its efforts to satisfy the other (that is, the entity would be able to transfer the product even if the customer declined maintenance services and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, in applying the principle in paragraph 606-10-25-21, that the entity's promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer. Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (that is, the product and the maintenance services) in the contract.

Case B — Implicit Promise of Service

606-10-55-154

The entity has historically provided maintenance services for no additional consideration (that is, "free") to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor, and the final contract between the entity and the distributor does not specify terms or conditions for those services.

606-10-55-155

However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create reasonable expectations of the entity's customers (that is, the distributor and end customers) in accordance with paragraph 606-10-25-16. Consequently, the entity assesses whether the promise of maintenance services is a performance obligation. For the same reasons as in Case A, the entity determines that the product and maintenance services are separate performance obligations.

Case C — Services Are Not a Promised Service

606-10-55-156

In the contract with the distributor, the entity does not promise to provide any maintenance services. In addition, the entity typically does not provide maintenance services, and, therefore, the entity's customary business practices, published policies, and specific statements at the time of entering into the contract have not created an implicit promise to provide goods or services to its customers. The entity transfers control of the product to the distributor and, therefore, the contract is completed. However, before the sale to the end customer, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.

606-10-55-157

The promise of maintenance is not included in the contract between the entity and the distributor at contract inception. That is, in accordance with paragraph 606-10-25-16, the entity does not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers. Consequently, the entity does not identify the promise to provide maintenance services as a performance obligation. Instead, the obligation to provide maintenance services is accounted for in accordance with Topic 450 on contingencies.

606-10-55-157A

Although the maintenance services are not a promised service in the current contract, in future contracts with customers the entity would assess whether it has created a business practice resulting in an implied promise to provide maintenance services.

How we see it

Some "free" goods or services commonly considered marketing incentives or incidental goods or services under legacy GAAP will have to be evaluated under the standard to determine whether they represent promised goods and services in a contract.

4.1.1 Promised goods or services that are immaterial in the context of a contract

As entities assess whether promised goods or services are performance obligations, the standard permits them to disregard goods and services that are deemed to be immaterial in the context of a contract. Because of this guidance, entities are not required to aggregate and assess immaterial items at the entity level. That is, when determining whether a good or service is immaterial in the context of a contract, the assessment is made based on the application of ASC 606 at the contract level, not in accordance with SAB Topic 1.M, which provides guidance on applying materiality thresholds to the preparation of financial statements filed with the SEC.

The Board decided that an entity is required to consider whether a promised good or service is material only at the contract level because it would be unduly burdensome to require an entity to aggregate and determine the effect on its financial statements of those items or activities determined to be immaterial at the contract level.[51] Further, the Board explained in the Basis for Conclusions of ASU 2016-10[52] that assessing immaterial goods or services might obscure, rather than clarify, the entity's performance obligation(s) in a contract and that an entity is not required to allocate revenue to promised goods or services that are immaterial in the context of a contract.

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[51] Paragraph BC12 of ASU 2016-10.

[52] Paragraph BC13 of ASU 2016-10.

The FASB noted in the Basis for Conclusions[53] that it did not intend for an entity to identify significantly more promised goods and services under the new standard than under legacy guidance, except for certain marketing incentives that generally are not considered deliverables under legacy guidance. However, ASC 606-10-25-16B states that this guidance that allows entities to disregard promises that are immaterial in the context of a contract may not be applied to customer options for additional goods or services. That is, an entity would still need to evaluate whether customer options for additional goods or services are material rights that should be accounted for as performance obligations in accordance with ASC 606-10-55-41 through 55-45 (see Section 4.6).

When evaluating whether a promised good or service is immaterial, an entity should consider the relative significance or importance of the good or service in the context of a contract as a whole. In doing so, entities will need to consider both quantitative and qualitative factors, just as they do when considering materiality in other areas of GAAP. If an entity determines that multiple goods or services are individually immaterial in the context of a contract, it will have to further assess the collective significance of those goods or services before concluding it is appropriate to consider them all immaterial in the context of the contract. This is because those individual immaterial items may be material in the aggregate to the contract. The Board explained in the Basis for Conclusions of ASU 2016-10[54] that an entity may not disregard some or all of those immaterial goods or services when identifying performance obligations if the disregarded goods or services are material to the contract in the aggregate. That is, an entity must account for a material portion of its promised goods or services in a contract and can't avoid accounting for any material portion of the contract.

The standard also contains guidance that requires entities to accrue for the costs of transferring immaterial goods or services to the customer in instances in which the costs will be incurred after the performance obligation (that includes those immaterial goods or services) has been satisfied. The FASB noted in the Basis for Conclusions of ASU 2016-10[55] that this requirement will more appropriately align the recognition of revenue and costs in the financial statements. The Board also observed that the cost accrual requirement in the standard only applies to items that are deemed to be promises *to a customer* in a contract. For example, an entity typically would not be required to accrue costs for operating a call desk to answer general inquiries about a product because doing that does not fulfill a promise to a customer.

How we see it

The inclusion of guidance that allows entities to disregard promised goods or services that are immaterial in the context of a contract will likely result in entities identifying similar promises to those that are identified as deliverables under legacy guidance (with some exceptions, such as certain types of marketing incentives). Although this assessment will require judgment, we anticipate that many of the promises deemed to be immaterial in the context of the contract will be similar to those items deemed inconsequential or perfunctory under the guidance in SAB Topic 13.

We also expect the cost accrual requirements in the new standard to be applied in a manner similar to the cost accrual guidance in SAB Topic 13, which requires that the costs to fulfill remaining performance obligations deemed inconsequential or perfunctory are accrued when revenue from the contract is recognized. We note that the Board used the guidance in SAB Topic 13 as a basis for the cost accrual guidance in the standard.

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[53] Paragraph BC11 of ASU 2016-10.

[54] Paragraph BC14 of ASU 2016-10.

[55] Paragraph BC16 of ASU 2016-10.

IASB differences

IFRS 15 does not include explicit language that an entity can disregard promised goods and services that are immaterial in the context of the contract. However, the IASB clarified in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that it did not intend for entities to individually identify every possible promised good or service.

Question 4-1 **How should an entity assess whether pre-production activities are a promised good or service?** [9 November 2015 TRG meeting; agenda paper no. 46]

TRG members generally agreed that the determination of whether pre-production activities are a promised good or service or fulfillment activities will require judgment and consideration of the facts and circumstances. Entities often need to perform pre-production activities before delivering any units under a production contract. For example, some long-term supply arrangements require an entity to perform up-front engineering and design services to create new, or adapt existing, technology to the needs of a customer.

TRG members generally agreed that if an entity is having difficulty determining whether a pre-production activity is a promised good or service in a contract, the entity should consider whether control of that good or service is transferred to the customer. For example, if an entity is performing engineering and development as part of developing a new product for a customer and the customer will own the intellectual property (e.g., patents) that results, the entity would likely conclude that it is transferring control of the intellectual property and that the engineering and development activities are a promised good or service in the contract.

However, TRG members noted that assessing whether control transfers in such arrangements may be challenging. In some arrangements, legal title of the good or service created from the pre-production activity is transferred to the customer. However, TRG members generally agreed that an entity would have to consider all indicators of control transfer under the new standard, and the transfer of legal title is not a presumptive indicator.

If a pre-production activity is determined to be a promised good or service, an entity will allocate a portion of the transaction price to that good or service (as a single performance obligation or as part of combined performance obligation that includes the pre-production activities along with other goods and services). If the pre-production activities are included in a performance obligation satisfied over time, they would be considered when measuring progress toward satisfaction of that performance obligation (see Section 7.1.4).

Question 4-2 **What is the nature of the promise in a "typical" stand-ready obligation?** [26 January 2015 TRG meeting; agenda paper no. 16]

TRG members discussed numerous examples of stand-ready obligations and generally agreed that the nature of the promise in a stand-ready obligation is the promise that the customer will have *access* to a good or service, not the delivery of the underlying good or service. The standard describes a stand-ready obligation as a promised service that consists of standing ready to provide goods or services or making goods or services available for a customer to use as and when it decides to do so. Stand-ready obligations are common in the software industry (e.g., unspecified updates to software on a when-and-if-available basis) and may be present in other industries.

The TRG agenda paper included the following types of promises to a customer that could be considered stand-ready obligations, depending on the facts and circumstances:

- Obligations for which the delivery of the good, service or intellectual property is within the control of the entity but is still being developed (e.g., a software vendor's promise to transfer unspecified software upgrades at its discretion)
- Obligations for which the delivery of the underlying good or service is outside the control of the entity and the customer (e.g., an entity's promise to remove snow from an airport runway in exchange for a fixed fee for the year)
- Obligations for which the delivery of the underlying good or service is within the control of the customer (e.g., an entity's promise to provide periodic maintenance on a when-and-if needed basis on a customer's equipment after a pre-established amount of usage by the customer)
- Obligations to make a good or service available to a customer continuously (e.g., a gym membership that provides unlimited access to a customer for a specified period of time)

An entity will need to carefully evaluate the facts and circumstances of its contracts to appropriately identify whether the nature of a promise to a customer is the delivery of the underlying good(s) or service(s) or the service of standing ready to provide goods or services. Entities also will have to consider other promises in a contract that includes a stand-ready obligation to appropriately identify the performance obligations in the contract. TRG members generally agreed[56] that all contracts with a stand-ready element do not necessarily include a single performance obligation (refer to Question 4-3 below).

At the TRG meeting, a FASB staff member said the staff does not believe that the FASB intended to change practice from legacy GAAP for determining when software/technology transactions include specified upgrade rights (i.e., a separate performance obligation) or unspecified upgrade rights (i.e., a stand-ready obligation).

Question 4-3 **Do all contracts with a stand-ready element include a single performance obligation that is satisfied over time?** [9 November 2015 TRG meeting; agenda paper no. 48]

TRG members generally agreed that the stand-ready element in a contract does not always represent a single performance obligation satisfied over time. This conclusion is consistent with the discussion in Question 4-2 that, when identifying the nature of a promise to a customer, an entity may determine that a stand-ready element exists but is not the promised good or service for revenue recognition purposes. Instead, the underlying goods or services are the goods or services promised to the customer and accounted for by the entity.

As an example, an entity may be required to stand ready to produce a part for a customer under a master supply arrangement (MSA). The customer is not obligated to purchase any parts (i.e., there is no minimum guaranteed volume); however, it is highly likely the customer will purchase parts because the part is required to manufacture the customer's product, and it is not practical for the customer to buy parts from multiple suppliers. TRG members generally agreed that the nature of the promise in this example is the delivery of the parts rather than a service of standing ready. When the customer submits a purchase order under the MSA, it is contracting for a specific number of distinct goods, and the purchase order creates new performance obligations for the entity. However, if the entity determined that the nature of the promise was a service of standing ready, the contract would be accounted for as a single performance obligation satisfied over time, and the entity may be required to estimate the number

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[56] 9 November 2015 TRG meeting; agenda paper no. 48.

of purchases to be made throughout the contract term (i.e., make an estimate of variable consideration and apply the constraint on variable consideration) and continually update the transaction price and its allocation among the transferred goods and services.

The TRG agenda paper also noted that in this example, the entity is not obligated to transfer any parts until the customer submits a purchase order (i.e., the customer makes a separate purchasing decision). This contrasts with a stand-ready obligation, which requires the entity to make a promised service available to the customer and doesn't require the customer to make any additional purchasing decisions.

See Question 4-12 for further discussion on determining whether a contract involving variable quantities of goods or services should be accounted for as variable consideration (i.e., if the nature of the promise is to transfer one overall service to the customer, such as a stand-ready obligation) or a contract containing customer options (i.e., if the nature of the promise is to transfer the underlying distinct goods or services.)

4.1.2 Shipping and handling activities

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that amended the guidance on identifying performance obligations to allow an entity to elect to account for shipping and handling activities performed after control of a good has been transferred to the customer as a fulfillment cost.

The standard allows entities to elect to account for shipping and handling activities performed after the control of a good has been transferred to the customer as a fulfillment cost (i.e., not a promised good or service), as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Identifying Performance Obligations

Promises in Contracts with Customers

606-10-25-18A

An entity that promises a good to a customer also might perform shipping and handling activities related to that good. If the shipping and handling activities are performed before the customer obtains control of the good (see paragraphs 606-10-25-23 through 25-30 for guidance on satisfying performance obligations), then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity's promise to transfer the good.

606-10-25-18B

If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The entity shall apply this accounting policy election consistently to similar types of transactions. An entity that makes this election would not evaluate whether shipping and handling activities are promised services to its customers. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued. An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

This election is intended to provide relief for entities that have free onboard shipping point arrangements and might otherwise determine that the act of shipping is a performance obligation under the standard. If that were the case, the entity would be required to allocate a portion of the transaction price to the shipping service and recognize it when (or as) the shipping occurs.

Shipping and handling activities performed before the transfer of control of a good are fulfillment activities rather than promised services because they relate to the entity's asset and not the customer's asset, and the costs are incurred to facilitate the sale of the good to the customer. The Board decided[57] that an entity's effort to deliver a good to a customer is no different from its efforts to procure raw materials, manufacture a good or ship a finished product from its manufacturing facility to its warehouse. Therefore, the question of whether shipping is a promised service in a contract is only relevant in situations in which shipping is performed after the customer has obtained control of the good.

The FASB noted in the Basis for Conclusions of ASU 2016-10[58] that it provided an accounting policy election to account for shipping as a fulfillment activity because requiring entities that do not account for shipping as a deliverable under legacy guidance to change practice would be costly for them to implement and would provide little or no benefit to financial statement users. However, the Board further explained[59] that it provided a policy election, rather than a requirement, because an entity should not be precluded from accounting for shipping and handling as a promised service if doing so would be more consistent with the nature of its contract with a customer.

The accounting policy election should be applied consistently to similar types of transactions. The election is not required to be made at an entity level because the Board recognized[60] that some entities sell multiple classes of goods and contracts might vary significantly for different classes of goods.

The standard also contains guidance that requires entities to accrue for fulfillment costs when they apply the policy election for shipping and handling activities. That is, entities are required to accrue for the costs of shipping and handling activities if revenue is recognized before contractually agreed shipping and handling activities occur. The FASB noted in the Basis for Conclusions of ASU 2016-10[61] that this requirement will more appropriately align the recognition of revenue and costs in the financial statements.

IASB differences

IFRS 15 does not include a similar election for shipping and handling activities. Accordingly, IFRS entities will need to assess all goods and services promised in a contract with a customer, including shipping and handling activities, in order to identify performance obligations.

[57] Paragraph BC22 of ASU 2016-10.
[58] Paragraph BC20 of ASU 2016-10.
[59] Paragraph BC21 of ASU 2016-10.
[60] Paragraph BC21 of ASU 2016-10.
[61] Paragraphs BC16 and BC25 of ASU 2016-10.

Question 4-4 **Can the shipping and handling election be applied to other types of activities (e.g., custodial or storage services) that occur after an entity transfers control of a good or service?**

The FASB explained in the Basis for Conclusions of ASU 2016-10[62] that the scope of the election is limited only to shipping and handling activities performed after the transfer of control of a good. As a result, it is inappropriate for an entity to apply the election by analogy to any other activities that are performed after control transfer, such as custodial or storage services. An entity should consider whether these other activities transfer a promised good or service to the customer under ASC 606-10-25-17. If the other activities represent a promised good or service, it is possible that an entity could determine that these activities are immaterial in the context of the contract in accordance with ASC 606-10-25-16A. An entity will need to apply judgment when evaluating whether those other activities are immaterial in the context of the contract.

4.2 Determining when promises are performance obligations

After identifying the promised goods and services within a contract, an entity determines which of those goods and services will be accounted for as separate performance obligations. That is, the entity decides what will be the individual units of accounting. Promised goods and services represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods and services) or if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer (see Section 4.2.2).

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. An entity will be required to account for all the goods or services promised in a contract as a single performance obligation if the entire bundle of promised goods and services is the only performance obligation identified. Refer to Section 4.3 for further discussion.

A single performance obligation may include a license of intellectual property and other promised goods or services. ASC 606-10-55-56 identifies two examples of licenses of intellectual property that are not distinct from other promised goods or services in a contract: (1) a license that is a component of a tangible good and that is integral to the functionality of the tangible good and (2) a license that the customer can benefit from only in conjunction with a related service (e.g., an online hosting service that enables a customer to access the content provided by the license of intellectual property). See Section 8.1.2 for further discussion on these two examples.

The standard also specifies that the following items are performance obligations: (1) customer options for additional goods or services that provide material rights to customers (see ASC 606-10-55-42 in Section 4.6) and (2) service-type warranties (see ASC 606-10-55-30 through 55-35 in Section 9.1.). Entities will not apply the general model to determine whether these goods or services are performance obligations because the Board deemed them to be performance obligations if they are identified as promises in a contract.

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[62] Paragraph BC23 of ASU 2016-10.

4.2.1 Determination of distinct

The standard outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct: (1) consideration at the level of the individual good or service (i.e., the good or service is capable of being distinct) and (2) consideration of whether the good or service is separable from other promises in the contract (i.e., the good or service is distinct within the context of the contract). Both of these criteria must be met to conclude that the good or service is distinct. If these criteria are met, the individual good or service must be accounted for as a separate unit of accounting (i.e., a performance obligation).

The Board concluded[63] that both steps are important to determine whether a promised good or service should be accounted for separately. The first criterion (i.e., capable of being distinct) establishes the minimum characteristics for a good or service to be accounted for separately. However, even if the individual goods or services promised in a contract may be capable of being distinct, it may not be appropriate to account for each of them separately because doing so would not result in a faithful depiction of the entity's performance in that contract or appropriately represent the nature of an entity's promise to the customer. Therefore, an entity would also need to consider the interrelationship of those goods or services to apply the second criterion (i.e., distinct within the context of the contract) and determine the performance obligations in a contract.

The standard provides the following guidance to determine whether a good or service is distinct:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Identifying Performance Obligations

Distinct Goods or Services

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 promise to transfer the good or service is distinct within the context of the contract).

4.2.1.1 Capable of being distinct

The first criterion requires that a promised good or service must be capable of being distinct by providing a benefit to the customer either on its own or together with other resources that are readily available to the customer. The Board explained in the Basis for Conclusions of ASU 2016-10[64] that this criterion establishes a baseline level of economic substance that a promised good or service must have in order to be distinct from other promises in a contract.

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[63] Paragraph BC102 of ASU 2014-09.

[64] Paragraph BC33(b) of ASU 2016-10.

The standard provides the following guidance on how to determine whether a promised good or service is capable of being distinct:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Identifying Performance Obligations

Distinct Goods or Services

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.

Determining whether a good or service is capable of being distinct will be straightforward in many situations. For example, if an entity regularly sells a good or service separately, that would demonstrate that the good or service provides benefit to a customer on its own or with other readily available resources.

The evaluation may require more judgment in other situations, particularly when the good or service can only provide benefit to the customer with readily available resources provided by other entities. These are resources that meet either of the following conditions:

- They are sold separately by the entity (or another entity).
- The customer has already obtained them 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.

As noted in the Basis for Conclusions of ASU 2014-09,[65] the assessment of whether the customer can benefit from the goods or services (either on its own or with other readily available resources) should be based on the characteristics of the goods or services themselves instead of how the customer might use the goods or services. Consistent with this notion, an entity should disregard any contractual limitations that may prevent the customer from obtaining readily available resources from a party other than the entity when making this assessment (as illustrated below in Example 11, Case D, excerpted in Section 4.2.3).

The Board also explained in the Basis for Conclusions of ASU 2014-09[66] that the guidance for determining whether a good or service is capable of being distinct is comparable to the guidance on accounting for multiple-element arrangements in ASC 605-25. That legacy guidance specifies that a delivered item must have value to the customer on a standalone basis for an entity to account for that item separately. However, the Board did not use similar terminology in the standard in order to avoid the

[65] Paragraph BC100 of ASU 2014-09.
[66] Paragraph BC101 of ASU 2014-09.

implication that an entity must assess a customer's intended use for a promised good or service when identifying performance obligations. It observed that it may be difficult, if not possible, for an entity to know a customer's intent.

4.2.1.2 Distinct within the context of the contract

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that clarified when a promised good or service is "separately identifiable" from other promises in a contract (i.e., distinct within the context of the contract). The amendments (1) reframed the principle for determining whether promised goods or services are separately identifiable to emphasize that the evaluation hinges on whether the multiple promised goods or services work together to deliver a combined output(s), (2) aligned the standard's three indicators for determining whether a promised good or service is separately identifiable with this principle and (3) added new examples and amended others to help entities apply these concepts.

Once an entity determines whether a promised good or service is capable of being distinct based on the individual characteristics of the promise, the entity considers the second criterion of whether the good or service is separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct in the context of the contract).

The standard provides the following guidance to make this determination:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Identifying Performance Obligations

Distinct Goods or Services

606-10-25-21

In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.

b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.

c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

Separately identifiable principle

To determine whether promised goods or services are separately identifiable (i.e., whether a promise to transfer a good or service is distinct in the context of the contract), an entity will need to evaluate whether the contract is to deliver (1) multiple promised goods or services or (2) a combined item(s) that is comprised of the individual goods or service promised in the contract. That is, an entity will need to evaluate whether the multiple promised goods and services to be delivered to the customer are *outputs* or *inputs* to a combined item(s). The Board noted in the Basis for Conclusions of ASU 2016-10[67] that, in many cases, a combined item(s) would be greater than (or substantially different from) the sum of the underlying promised goods and services. The standard includes several examples to help entities further understand the separately identifiable principle. See Section 4.2.3 for full excerpts of these examples.

The evaluation of the separately identifiable principle should consider the utility of the promised goods or services (i.e., the ability of each good or service to provide benefit or value). As discussed in the Basis for Conclusions of ASU 2016-10,[68] an entity may be able to fulfill its promise to transfer each good or service in a contract independently of the other goods or services, but if each good or service significantly affects the other's utility to the customer, the promises would not be separately identifiable. The Board also noted that the capable of being distinct criterion also considers the utility of the promised good or service, but merely establishes a *baseline* level of economic substance a good or service must have to be capable of being distinct. In contrast, the separately identifiable criterion looks at the customer's ability to derive its *intended* benefit from the contract. For example, if two or more promises are capable of being distinct because the customer can derive some measure of benefit from each one individually, but the customer's ability to derive the intended benefit from the contract significantly depends on the entity transferring all of those goods or services, those promises would need to be combined into a single performance obligation because they are not separately identifiable in the context of the contract.

The FASB also explained[69] that the separately identifiable principle is intended to consider the level of integration, interrelation or interdependence among the multiple promised goods or services in a contract. That is, the principle is intended to help an entity evaluate when its performance in transferring a bundle of goods or services is, in substance, fulfilling a single promise to a customer. In evaluating how it fulfills its promises in a contract, an entity may also consider the notion of "separable risks"[70] and the relationship between the various goods or services in the contract. When considering the risks an entity undertakes in fulfilling its promises in a contract, it could conclude that individual goods or services in a bundle are not distinct if the risk that it assumes in transferring one of the promised goods or services to the customer is inseparable from the risk relating to the transfer of the other promised goods or services in the bundle. Therefore, to apply the separately identifiable principle, an entity should evaluate how two or more promised goods or services affect each other and not just evaluate whether one item, by its nature, depends on the other (e.g., an undelivered item that would never be obtained by a customer who didn't purchase the delivered item in the contract). That is, the conclusion about whether the promised goods or services are separately identifiable hinges on whether there is a *two-way dependency* between the items.

As an example of this evaluation, the FASB discussed in the Basis for Conclusions of ASU 2014-09[71] a typical construction contract that involves transferring to the customer many goods and services that are capable of being distinct (e.g., various building materials, labor, project management services). In this example, the FASB concluded that identifying all of the individual goods and services as separate performance obligations would be impractical and would not faithfully represent the nature of the

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[67] Paragraph BC29 of ASU 2016-10.
[68] Paragraph BC33(b) of ASU 2016-10.
[69] Paragraph BC32 of ASU 2016-10.
[70] Paragraph BC30 of ASU 2016-10.
[71] Paragraph BC102 of ASU 2014-09.

entity's promise to the customer. That is, the entity would recognize revenue when the materials and other inputs to the construction process are provided rather than when it performs (and uses those inputs) in the construction of the item the customer has contracted to receive (e.g., a building, a house). As such, when determining whether a promised good or service is distinct, an entity will not only determine whether the good or service is capable of being distinct but also whether the promise to transfer the good or service is distinct within the context of the contract.

ASC 606-10-25-21 includes three factors (discussed individually below) that are intended to help entities identify when the promises in a bundle of promised goods or services are *not* separately identifiable and, therefore, should be combined into a single performance obligation. The FASB noted in the Basis for Conclusions of ASU 2016-10[72] that these three factors are not an exhaustive list and that not all of the factors need to be met in order to conclude that the entity's promised goods or services are not distinct and should be combined. The three factors also are not intended to be criteria that are evaluated independently of the separately identifiable principle. Given the wide variety of contracts that are within the scope of the standard, the Board concluded that there may be some instances in which the factors are less relevant to the evaluation of the separately identifiable principle. Entities may need to apply significant judgment to evaluate whether a promised good or service is separately identifiable. The evaluation will require a thorough understanding of the facts and circumstances present in each contract.

Significant integration service

The first factor included in ASC 606-10-25-21(a) is the presence of a significant integration service. The FASB determined[73] that, in circumstances in which an entity provides a significant service of integrating a good or service with other goods or services in a contract, the bundle of integrated goods or services represents a combined output or outputs. Said differently, in circumstances in which an entity provides a significant integration service, the risk of transferring individual goods or services is inseparable from the bundle of integrated goods or services because a substantial part of an entity's promise to the customer is to make sure the individual goods or services are incorporated into the combined output or outputs.

This factor applies even if there is more than one output. Further, as described in the standard, a combined output or outputs may include more than one phase, element or unit.

In the Basis for Conclusions of ASU 2014-09,[74] the FASB noted that this factor may be relevant in many construction contracts in which a contractor provides an integration (or contract management) service to manage and coordinate the various construction tasks and to assume the risks associated with the integration of those tasks. An integration service provided by the contractor often includes coordinating the activities performed by any subcontractors and making sure the quality of the work performed is in compliance with contract specifications and that the individual goods or services are appropriately integrated into the combined item the customer has contracted to receive. The Board also observed that this factor could apply to other industries as well.

Significant modification or customization

The second factor in ASC 606-10-25-21(b) is the presence of significant modification or customization. The FASB explained in the Basis for Conclusions of ASU 2014-09[75] that in some industries, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customizes another. This is because if a good or service modifies or customizes another good or service in a contract, each good or service is being assembled together (as an input) to produce a combined output.

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[72] Paragraph BC31 of ASU 2016-10.
[73] Paragraph BC107 of ASU 2014-09.
[74] Paragraph BC107 of ASU 2014-09.
[75] Paragraph BC109 of ASU 2014-09.

For example, assume that an entity promises to provide a customer with software that it will significantly customize to make the software function with the customer's existing infrastructure. Based on its facts and circumstances, the entity determines that it is providing the customer with a fully integrated system and that the customization service requires it to significantly modify the software in such a way that the risks of providing it and the customization service are inseparable (i.e., the software and customization service are not separately identifiable.)

Highly interdependent or highly interrelated

The third factor in ASC 606-10-25-21(c) is whether the promised goods or services are highly interdependent or highly interrelated. Promised goods or services are highly interdependent or highly interrelated if each of the promised goods or services is significantly affected by one or more of the other goods or services in the contract. As discussed above, the Board clarified that an entity should evaluate whether there is a *two-way dependency* between the promised goods or services to determine whether the promises are highly dependent or highly interrelated.

Examples

The FASB included a number of examples in the standard that illustrate the application of the guidance on identifying performance obligations. The examples include an analysis of how an entity may determine whether the promises to transfer goods or services are distinct in the context of the contract. Refer to Section 4.2.3 below for full excerpts of several of these examples.

How we see it

The first step of the two-step process to determine whether goods or services are distinct is similar to the principles for determining separate units of accounting under legacy guidance in ASC 605-25. However, the second step of considering the goods or services within the context of the contract is a new requirement. Therefore, entities will need to carefully evaluate this second step to determine whether their historical units of accounting for revenue recognition may need to change. This evaluation may require an entity to use significant judgment.

It is important to note that the assessment of whether a good or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular good or service is distinct (or not distinct) in all instances. The manner in which promised goods and services are bundled in a contract can affect the conclusion of whether a good or service is distinct. We anticipate that entities may end up treating the same goods and services differently, depending on how those goods and services are bundled in a contract.

4.2.2 Series of distinct goods and services that are substantially the same and that have the same pattern of transfer

As discussed above, ASC 606-10-25-14(b) defines as a second type of performance obligation — a promise to transfer to the customer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer, if both of the following criteria from ASC 606-10-25-15 are met:

- Each distinct good or service in the series that the entity promises to transfer represents a performance obligation that would be satisfied over time in accordance with ASC 606-10-25-27 (see Section 7.1) if it were accounted for separately.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see Section 7.1.4).

If a series of distinct goods or services meets the criteria in ASC 606-10-25-14(b) and 25-15 (the series provision), an entity is required to treat that series as a single performance obligation (i.e., it is not optional guidance). The Board incorporated this guidance[76] to simplify the model and promote consistent identification of performance obligations in cases when an entity provides the same good or service over a period of time. Without the series provision, the Board noted[77] that applying the revenue model might present operational challenges because an entity would have to identify multiple distinct goods or services, allocate the transaction price to each distinct good or service on a standalone selling price basis, and then recognize revenue when those performance obligations are satisfied. The FASB determined that this would not be cost effective. Instead, an entity will identify a single performance obligation and allocate the transaction price to that performance obligation. It will then recognize revenue by applying a single measure of progress to that performance obligation.

For distinct goods or services to be accounted for as a series, they must be substantially the same. In the Basis for Conclusions of ASU 2014-09,[78] the Board provided three examples of repetitive services (i.e., cleaning, transaction processing and delivering electricity) that meet the series provision. In addition, TRG members[79] generally agreed that when determining whether distinct goods or services are substantially the same, entities will need to first determine the nature of their promise. This is because a series could consist of either specified quantities of the underlying good or service delivered (e.g., each unit of a good) or distinct time increments (e.g., an hourly service), depending on the nature of the promise. That is, if the nature of the promise is to deliver a specified quantity of service (e.g., monthly payroll services over a defined contract period), the evaluation should consider whether each *service* is distinct and substantially the same. In contrast, if the nature of the entity's promise is to stand ready or provide a single service for a period of time (i.e., because there is an unspecified quantity to be delivered), the evaluation should consider whether each *time increment* (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same.

It is important to highlight that even if the underlying activities an entity performs to satisfy a promise vary significantly throughout the day and from day to day, that fact, by itself, does not mean the distinct goods or services are not substantially the same. Consider Example 12A in the standard (excerpted in full in Section 4.2.3), where the nature of the promise is to provide a daily hotel management service. The service is comprised of activities that may vary each day (e.g., cleaning services, reservation services, property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day, and the entity is providing the same overall management service each day. See Question 4-7 for further discussion on determining the nature of an entity's promise and evaluating the substantially the same criterion.

A TRG agenda paper[80] discussed at the July 2015 TRG meeting explained that when considering the nature of the entity's promise and the applicability of the series provision, including whether a good or service is distinct, it may be helpful to consider which over-time criterion in ASC 606-10-25-27 was met (i.e., why the entity concluded that the performance obligation is satisfied over time). As discussed further in Section 7.1, a performance obligation is satisfied over time if one of three criteria are met. For example, if a performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits provided as the entity performs (i.e., the first over-time criterion in ASC 606-10-25-27(a)), that might indicate that each increment of service is capable of being distinct. If that's the case, the entity would need to evaluate whether each increment of service is separately identifiable (and

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[76] Paragraph BC113 of ASU 2014-09.
[77] Paragraph BC114 of ASU 2014-09.
[78] Paragraph BC114 of ASU 2014-09.
[79] 13 July 2015 TRG meeting; agenda paper no. 39.
[80] 13 July 2015 TRG meeting; agenda paper no. 39.

substantially the same). If a performance obligation is satisfied over time based on the other two criteria in ASC 606-10-25-27 (i.e., (1) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced or (2) 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), the nature of that promise might be to deliver a single specified good or service (e.g., a contract to construct a single piece of equipment), which would not be considered a series because the individual goods or services within that performance obligation are not distinct.

An entity's determination of whether a performance obligation is a single performance obligation comprising a series of distinct goods or services or a single performance obligation comprising goods or services that are not distinct from one another will affect the accounting in the following areas: (1) allocation of variable consideration (see Chapter 6), (2) contract modifications (see Section 3.4) and (3) changes in transaction price (see Section 6.5). This is because, as the FASB discussed in the Basis for Conclusions in ASU 2014-09[81] and members of the TRG discussed at their March 2015 meeting,[82] an entity should consider the *underlying* distinct goods or services in the contract, rather than the single performance obligation identified under the series provision, when applying the guidance for these three areas of the model.

The following example, included in a TRG agenda paper,[83] illustrates how the allocation of variable consideration may differ for a single performance obligation identified under the series provision and a single performance obligation comprising non-distinct goods and/or services. Consider a five-year service contract that includes payment terms of a fixed annual fee plus a performance bonus upon completion of a milestone at the end of year two. If the entire service period is determined to be a single performance obligation comprising a series of distinct services, the entity may be able to conclude that the variable consideration (i.e., the bonus amount) should be allocated directly to its efforts to perform the distinct services up to the date that the milestone is achieved (e.g., the underlying distinct services in years one and two). This would result in the entity recognizing the entire bonus amount, if earned, at the end of year two. See Question 4-7 for several examples of services for which it would be reasonably to conclude that they meet the series provision.

In contrast, if the entity determines that the entire service period is a single performance obligation that is comprised of non-distinct services, the bonus would be included in the transaction price (subject to the constraint on variable consideration — see Section 5.2.3) and recognized based on the measure of progress determined for the entire service period. For example, if the bonus becomes part of the transaction price at the end of year two (when it is probable to be earned and not subject to a revenue reversal), a portion of the bonus would be recognized at that date based on performance completed to-date and a portion would be recognized as the remainder of the performance obligation is satisfied. As a result, the bonus amount would be recognized as revenue through the end of the five-year service period.

How we see it

The series provision is a new concept, and we believe that entities may need to apply significant judgment when determining whether a promised good or service in a contract with a customer meets the criteria to be accounted for as a series of distinct goods or services. As illustrated in Question 4-7 below, promised goods or services that meet the series criteria are not limited to a particular industry and can encompass a wide array of promised goods and services.

Entities should consider whether they need to add or make changes to their business processes or internal controls as a result of this new requirement.

[81] Paragraph BC115 of ASU 2014-09.

[82] 30 March 2015 TRG meeting; agenda paper no. 27.

[83] 30 March 2015 TRG meeting; agenda paper no. 27.

Question 4-5 **In order to apply the series provision, must the goods or services be consecutively transferred?** [30 March 2015 TRG meeting; agenda paper no. 27]

TRG members generally agreed that a series of distinct goods or services need not be consecutively transferred. That is, the series provision must be applied when there is a gap or an overlap in an entity's transfer of goods or services, provided that the other criteria are met.

Stakeholders had asked this question because the Basis for Conclusions of ASU 2014-09 uses the term "consecutively" in discussions of the series provision.[84] However, the TRG agenda paper concluded that the Board's discussion was not meant to imply that the series provision *only* applies to circumstances in which the entity provides the same good or service consecutively over a period of time.

The TRG agenda paper included an example of a contract under which an entity provides a manufacturing service producing 24,000 units of a product over a two-year period. The conclusion in the TRG agenda paper was that the criteria for the series provision in ASC 606-10-25-15 were met because the units produced under the service arrangement were substantially the same and were distinct services that would be satisfied over time (see Section 7.1) because the units are manufactured to meet the customer's specifications (i.e., the entity's performance does not create an asset with alternative use to the entity), and if the contract were to be cancelled, the entity would have an enforceable right to payment (cost plus a reasonable profit margin).

The conclusion in the TRG agenda paper was not influenced by whether the entity would perform the service evenly over the two-year period (e.g., produce 1,000 units per month). That is, the entity could produce 2,000 units in some months and none in others, but this would not be a determining factor in concluding whether the contract met the criteria to be accounted for as a series.

Question 4-6 **In order to apply the series provision, does the accounting result need to be the same as if the underlying distinct goods and services were accounted for as separate performance obligations?** [30 March 2015 TRG meeting; agenda paper no. 27]

TRG members generally agreed that the accounting result does not need to be the same and that an entity is not required to prove that the result would be the same as if the goods and services were accounted for as separate performance obligations.

Question 4-7 **In order to apply the series provision, how should an entity consider whether a performance obligation consists of distinct goods or services that are "substantially the same?"** [13 July 2015 TRG meeting; agenda paper no. 39]

As discussed above, TRG members generally agreed that the TRG agenda paper, which primarily focused on the application of the series provision to service contracts, will help entities understand the standard's requirement to determine whether a performance obligation consists of goods or services that are distinct and "substantially the same."

The TRG agenda paper noted that when making the evaluation of whether goods or services are distinct and substantially the same, an entity needs to first determine the nature of the entity's promise in providing services to the customer. That is, if the nature of the promise is to deliver a specified quantity of service (e.g., monthly payroll services over a defined contract period), the evaluation should consider whether each service is distinct and substantially the same. In contrast, if the nature of the entity's promise is to stand ready or provide a single service for a period of time (i.e., because there is an

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[84] Paragraphs BC113 and BC116 of ASU 2014-09.

unspecified quantity to be delivered), the evaluation should consider whether each time increment (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same. The TRG agenda paper noted that the Board intended that a series could consist of either specified quantities of the underlying good or service delivered (e.g., each unit of a good) or distinct time increments (e.g., an hourly service), depending on the nature of the promise.

As discussed above in Section 4.2.2, it is important to highlight that the underlying activities an entity performs to satisfy a performance obligation could vary significantly throughout a day and from day to day, but the TRG agenda paper noted that is not determinative to the conclusion of whether a performance obligation consists of goods or services that are distinct and substantially the same. Consider Example 12A (excerpted in full in Section 4.2.3) of the standard for which the nature of the promise is to provide a daily hotel management service. The hotel management service comprises various activities that may vary each day (e.g., cleaning services, reservation services, property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day.

The TRG agenda paper included several examples of promised goods and services that may meet the series provision and the analysis that supports that conclusion. The evaluation of the nature of the promise for each example is consistent with Example 13 and Example 12A of the standard on monthly payroll processing and hotel management services, respectively. Below we have summarized some of the examples and analysis in the TRG agenda paper:

Example of IT outsourcing

A vendor and customer execute a 10-year information technology (IT) outsourcing arrangement in which the vendor continuously delivers the outsourced activities over the contract term (e.g., it provides server capacity, manages the customer's software portfolio, runs an IT help desk). The total monthly invoice is calculated based on different units consumed for the respective activities, and the vendor concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs (meeting over-time criterion ASC 606-10-25-27(a)).

The vendor first considers the nature of its promise to the customer. Because the vendor has promised to provide an unspecified quantity of activities, rather than a defined number of services, the TRG agenda paper noted that the vendor could reasonably conclude that the nature of the promise is an obligation to stand ready to provide the integrated outsourcing service each day. If the nature of the promise is the overall IT outsourcing service, each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day is separately identifiable. The TRG agenda paper also noted that the vendor could reasonably conclude that each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day.

Accordingly, it would be reasonable for an entity to conclude that this contract meets the series provision.

Example of transaction processing

A vendor enters into a 10-year contract with a customer to provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use the vendor's system, but the ultimate quantity of transactions is unknown. The vendor concludes that the customer simultaneously receives and consumes the benefits as it performs.

If the vendor concludes that the nature of its promise is to provide continuous access to its system rather than process a particular quantity of transactions, it might conclude that there is a single performance obligation to stand ready to process as many transactions as the customer requires. If that is the case, the TRG agenda paper noted that it would be reasonable to conclude that there are multiple distinct time increments of the service. Each day of access to the service provided to the customer could be considered substantially the same since the customer is deriving a consistent benefit from the access each day, even if a different number of transactions are processed each day.

If the vendor concludes that the nature of the promise is the processing of each transaction, the TRG agenda paper noted that each transaction processed could be considered substantially the same even if there are multiple types of transactions that generate different payments. Further, the TRG agenda paper noted that each transaction processed could be a distinct service because the customer could benefit from each transaction on its own and each transaction could be separately identifiable.

Accordingly, it would be reasonable for an entity to conclude that this contract meets the series provision.

Example of hotel management

A hotel manager (HM) enters into a 20-year contract to manage properties on behalf of a customer. HM receives monthly consideration of 1% of monthly rental revenue, plus reimbursement of labor costs incurred to perform the service and an annual incentive payment. HM concludes that the customer simultaneously receives and consumes the benefits of its services as it performs.

HM considers the nature of its promise to the customer. If the nature of its promise is the overall management service (because the underlying activities are not distinct from each other), the TRG agenda paper noted that each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day of service is separately identifiable.

Assuming the nature of the promise is the overall management service, the TRG agenda paper noted that the service performed each day could be considered distinct and substantially the same, consistent with Example 12A in the standard. That is because even if the individual activities that comprise the performance obligation vary significantly throughout the day and from day to day, the nature of the *overall promise* to provide the management service is the same from day to day.

Accordingly, it would be reasonable for an entity to conclude that this contract meets the series provision.

4.2.3 Examples of identifying performance obligations

The standard includes several examples that illustrate the application of the guidance on identifying performance obligations. The examples explain the judgments made to determine whether the promises to transfer goods or services are capable of being distinct and distinct in the context of the contract. We have excerpted these examples below.

In the Basis for Conclusions of ASU 2016-10,[85] the Board cautioned that the examples provided are not intended to establish explicit boundaries, and that no single fact or circumstance should be viewed as determinative. It further noted that some of the examples are based on fact patterns that entities thought were challenging to assess under the standard.

The following example illustrates contracts with promised goods and services that, while capable of being distinct, are not distinct in the context of the contract because of a significant integration service that combines the inputs (the underlying goods and services) into a combined output:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 10 — Goods and Services Are Not Distinct

Case A — Significant Integration Service

606-10-55-137

An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

606-10-55-138

The promised goods and services are capable of being distinct in accordance with paragraph 606-10-25-19(a). That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.

606-10-55-139

However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

606-10-55-140

Because both criteria in paragraph 606-10-25-19 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

Case B — Significant Integration Service

606-10-55-140A

An entity enters into a contract with a customer that will result in the delivery of multiple units of a highly complex, specialized device. The terms of the contract require the entity to establish a manufacturing process in order to produce the contracted units. The specifications are unique to the customer based on a custom design that is owned by the customer and that were developed under the terms of a separate contract that is not part of the current negotiated exchange. The entity is responsible for the overall management of the contract, which requires the performance and integration of various activities including procurement of materials; identifying and managing subcontractors; and performing manufacturing, assembly, and testing.

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[85] Paragraph BC34 of ASU 2016-10.

606-10-55-140B

The entity assesses the promises in the contract and determines that each of the promised devices is capable of being distinct in accordance with paragraph 606-10-25-19(a) because the customer can benefit from each device on its own. This is because each unit can function independently of the other units.

606-10-55-140C

The entity observes that the nature of its promise is to establish and provide a service of producing the full complement of devices for which the customer has contracted in accordance with the customer's specifications. The entity considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output) and, therefore, the devices and the various promised goods and services inherent in producing those devices are not separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. In this Case, the manufacturing process provided by the entity is specific to its contract with the customer. In addition, the nature of the entity's performance and, in particular, the significant integration service of the various activities mean that a change in one of the entity's activities to produce the devices has a significant effect on the other activities required to produce the highly complex specialized devices such that the entity's activities are highly interdependent and highly interrelated. Because the criterion in paragraph 606-10-25-19(b) is not met, the goods and services that will be provided by the entity are not separately identifiable, and, therefore, are not distinct. The entity accounts for all of the goods and services promised in the contract as a single performance obligation.

The determination of whether a "significant integration service" exists within a contract, as illustrated in Case A and Case B above, will require significant judgment and will be heavily dependent on the unique facts and circumstances for each individual contract with a customer.

The following example illustrates a contract for which the promised goods or services are combined into a single performance obligation because of a promised service that significantly modifies the other promise in the contract. The example also highlights, in applying the separately identifiable principle, the notion of "utility" and how the promised service is critical to maintain the intended use and benefit of the other promise:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 10 — Goods and Services Are Not Distinct

Case C — Combined Item

606-10-55-140D

An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

606-10-55-140E

The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

606-10-55-140F

The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

The following example illustrates how the significance of installation services can affect an entity's conclusion about the number of identified performance obligations for similar fact patterns. In Case A, each of the promised goods and services are determined to be distinct. In Case B, two of the promised goods and services are combined into a performance obligation because one promise (the installation) significantly customizes another promise (the software).

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 11 — Determining Whether Goods or Services Are Distinct

Case A — Distinct Goods or Services

606-10-55-141

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

606-10-55-142

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

606-10-55-143

The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In reaching this determination the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because, in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

606-10-55-144

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

a. The software license

b. An installation service

c. Software updates

d. Technical support.

606-10-55-145

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software license in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A (see Example 54 in paragraphs 606-10-55-362 through 55-363B).

Case B — Significant Customization

606-10-55-146

The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

606-10-55-147

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

606-10-55-148

On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

606-10-55-149

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization (which is comprised of the license to the software and the customized installation service)

b. Software updates

c. Technical support.

606-10-55-150

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

The following example illustrates contracts that include multiple promised goods or services, all of which are determined to be distinct. The example highlights the importance of considering both the separately identifiable principle and the underlying factors in ASC 606-10-25-21.

Case C illustrates a contract that includes the sale of equipment and installation services. The equipment can be operated without any customization or modification, and the installation is not complex and can be performed by other vendors. The entity determines that the two promises in the contract are distinct.

Case D illustrates that certain types of contractual restrictions, including those that require a customer to use only the entity's services, should not affect the evaluation of whether a promised good or service is distinct.

Case E illustrates a contract that includes the sale of equipment and specialized consumables to be used with the equipment. Even though the consumables can only be produced by the entity, they are sold separately. The entity determines that the two promises in the contract are distinct and walks through the analysis for determining whether the promises are capable of being distinct and distinct in the context of the contract.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 11 — Determining Whether Goods or Services Are Distinct

Case C — Promises Are Separately Identifiable (Installation)

606-10-55-150A

An entity contracts with a customer to sell a piece of equipment and installation services. The equipment is operational without any customization or modification. The installation required is not complex and is capable of being performed by several alternative service providers.

606-10-55-150B

The entity identifies two promised goods and services in the contract: (a) equipment and (b) installation. The entity assesses the criteria in paragraph 606-10-25-19 to determine whether each promised good or service is distinct. The entity determines that the equipment and the installation each meet the criterion in paragraph 606-10-25-19(a). The customer can benefit from the equipment on its own, by using it or reselling it for an amount greater than scrap value, or together with other readily available resources (for example, installation services available from alternative providers). The customer also can benefit from the installation services together with other resources that the customer will already have obtained from the entity (that is, the equipment).

606-10-55-150C

The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (in accordance with paragraph 606-10-25-19(b)). The entity considers the principle and 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. In this Case, each of the factors in paragraph 606-10-25-21 contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable as follows:

a. The entity is not providing a significant integration service. That is, the entity has promised to deliver the equipment and then install it; the entity would be able to fulfill its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.

b. The entity's installation services will not significantly customize or significantly modify the equipment.

c. Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfill its promise to transfer the equipment independently of its promise to provide the installation services. Because the equipment and the installation services do not each significantly affect the other, they are not highly interdependent or highly interrelated.

On the basis of this assessment, the entity identifies two performance obligations (the equipment and installation services) in the contract.

606-10-55-150D

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

Case D — Promises Are Separately Identifiable (Contractual Restrictions)

606-10-55-150E

Assume the same facts as in Case C, except that the customer is contractually required to use the entity's installation services.

606-10-55-150F

The contractual requirement to use the entity's installation services does not change the evaluation of whether the promised goods and services are distinct in this Case. This is because the contractual requirement to use the entity's installation services does not change the characteristics of the goods or services themselves, nor does it change the entity's promises to the customer. Although the customer is required to use the entity's installation services, the equipment and the installation services are capable of being distinct (that is, they each meet the criterion in paragraph 606-10-25-19(a)), and the entity's promises to provide the equipment and to provide the installation services are each separately identifiable (that is, they each meet the criterion in paragraph 606-10-25-19(b)). The entity's analysis in this regard is consistent with Case C.

Case E — Promises Are Separately Identifiable (Consumables)

606-10-55-150G

An entity enters into a contract with a customer to provide a piece of off-the-shelf equipment (that is, it is operational without any significant customization or modification) and to provide specialized consumables for use in the equipment at predetermined intervals over the next three years. The consumables are produced only by the entity, but are sold separately by the entity.

606-10-55-150H

The entity determines that the customer can benefit from the equipment together with the readily available consumables. The consumables are readily available in accordance with paragraph 606-10-25-20 because they are regularly sold separately by the entity (that is, through refill orders to customers that previously purchased the equipment). The customer can benefit from the consumables that will be delivered under the contract together with the delivered equipment that is transferred to the customer initially under the contract. Therefore, the equipment and the consumables are each capable of being distinct in accordance with paragraph 606-10-25-19(a).

606-10-55-150I

The entity determines that its promises to transfer the equipment and to provide consumables over a three-year period are each separately identifiable in accordance with paragraph 606-10-25-19(b). In determining that the equipment and the consumables are not inputs to a combined item in this contract, the entity considers that it is not providing a significant integration service that transforms the equipment and consumables into a combined output. Additionally, neither the equipment nor the consumables are significantly customized or modified by the other. Lastly, the entity concludes that the equipment and the consumables are not highly interdependent or highly interrelated because they do not significantly affect each other. Although the customer can benefit from the consumables in this contract only after it has obtained control of the equipment (that is, the consumables would have no use without the equipment) and the consumables are required for the equipment to function, the equipment and the consumables do not each significantly affect the other. This is because the entity would be able to fulfill each of its promises in the contract independently of the other. That is, the entity would be able to fulfill its promise to transfer the equipment even if the customer did not purchase any consumables and would be able to fulfill its promise to provide the consumables even if the customer acquired the equipment separately.

606-10-55-150J

On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

a. The equipment

b. The consumables.

606-10-55-150K

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

The following example illustrates a series of distinct services that meet the criteria to be accounted for as a single performance obligation under the series provision (as discussed in Section 4.2.2 above):

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 12A — Series of Distinct Goods or Services

606-10-55-157B

An entity, a hotel manager, enters into a contract with a customer to manage a customer-owned property for 20 years. The entity receives consideration monthly that is equal to 1 percent of the revenue from the customer-owned property.

606-10-55-157C

The entity evaluates the nature of its promise to the customer in this contract and determines that its promise is to provide a hotel management service. The service comprises various activities that may vary each day (for example, cleaning services, reservation services, and property maintenance). However, those tasks are activities to fulfill the hotel management service and are not separate promises in the contract. The entity determines that each increment of the promised service (for example, each day of the management service) is distinct in accordance with paragraph 606-10-25-19. This is because the customer can benefit from each increment of service on its own (that is, it is capable of being distinct) and each increment of service is separately identifiable because no day of service significantly modifies or customizes another and no day of service significantly affects either the entity's ability to fulfill another day of service or the benefit to the customer of another day of service.

606-10-55-157D

The entity also evaluates whether it is providing a series of distinct goods or services in accordance with paragraphs 606-10-25-14 through 25-15. First, the entity determines that the services provided each day are substantially the same. This is because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day (although the underlying tasks or activities the entity performs to provide that service may vary from day to day). The entity then determines that the services have the same pattern of transfer to the customer because both criteria in paragraph 606-10-25-15 are met. The entity determines that the criterion in paragraph 606-10-25-15(a) is met because each distinct service meets the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time. The customer simultaneously receives and consumes the benefits provided by the entity as it performs. The entity determines that the criterion in paragraph 606-10-25-15(b) also is met because the same measure of progress (in this case, a time-based output method) would be used to measure the entity's progress toward satisfying its promise to provide the hotel management service each day.

606-10-55-157E

After determining that the entity is providing a series of distinct daily hotel management services over the 20-year management period, the entity next determines the transaction price. The entity determines that the entire amount of the consideration is variable consideration. The entity considers whether the variable consideration may be allocated to one or more, but not all, of the distinct days of service in the series in accordance with paragraph 606-10-32-39(b). The entity evaluates the criteria in paragraph 606-10-32-40 and determines that the terms of the variable consideration relate specifically to the entity's efforts to transfer each distinct daily service and that allocation of the variable consideration earned based on the activities performed by the entity each day to the distinct day in which those activities are performed is consistent with the overall allocation objective. Therefore, as each distinct daily service is completed, the variable consideration allocated to that period may be recognized, subject to the constraint on variable consideration.

4.3 Promised goods and services that are not distinct

If a promised good or service does not meet the criteria to be considered distinct, it is required to be combined with other promised goods or services until a distinct bundle of goods or services exists. This could result in an entity combining a good or service that is not considered distinct with another good or service that, on its own, would have met the criteria to be considered distinct (see Section 4.2.1).

The standard includes the following guidance on this topic:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Identifying Performance Obligations

Distinct 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**.

The standard provides two examples of contracts with promised goods and services that, while capable of being distinct, are not distinct in the context of the contract because of a significant integration service that combines the inputs (the underlying goods and services) into a combined output. Full excerpts of these examples (Example 10, Case A, and Example 10, Case B) are included in Section 4.2.3 above.

4.4 Principal versus agent considerations

FASB amendments

In March 2016, the FASB issued ASU 2016-08 that amended the principal versus agent guidance to clarify how an entity should identify the unit of accounting (i.e., the specified good or service) for the principal versus agent evaluation and how the control principle applies to certain types of arrangements such as service transactions. The amendments also reframed the indicators to focus on evidence that an entity is acting as a principal rather than as an agent, revised existing examples and added new ones.

When more than one party is involved in providing goods or services to a customer, the standard requires an entity to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services.

The FASB explained in the Basis for Conclusions of ASU 2016-08[86] that in order for an entity to conclude that it is providing the good or service to the customer, it must first control that good or service. That is, the entity cannot provide the good or service to a customer if the entity does not first control it. If an entity controls the good or service, the entity is a principal in the transaction. If an entity does not control the good or service before it is transferred to the customer, the entity is an agent in the transaction.

The Board noted in the Basis for Conclusions of ASU 2016-08[87] that an entity that itself manufactures a good or performs a service is always a principal if it transfers control of that good or service to another party. There is no need for such an entity to evaluate the principal versus agent guidance because it transfers control of or provides its own good or service directly to its customer without the involvement of another party. For example, if an entity transfers control of a good to an intermediary that is a principal in providing that good to an end customer, the entity records revenue as a principal in the sale of the good to its customer (the intermediary).

How we see it

Consistent with legacy GAAP, entities will need to carefully evaluate whether a gross or net presentation is appropriate. While the standard includes guidance that is similar to legacy GAAP on principal versus agent, the key difference is that the new guidance focuses on control of the specified goods and services as the overarching principle for entities to consider in determining whether they are acting as a principal or an agent. This could result in entities reaching different conclusions than they do under legacy GAAP.

The standard states the overall principle for the principal versus agent evaluation as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Principal versus Agent Considerations

606-10-55-36

When another party is involved in providing goods or services to a **customer**, the entity should determine whether the nature of its promise is a **performance obligation** to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a **contract** with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

[86] Paragraph BC12 of ASU 2016-08.

[87] Paragraph BC13 of ASU 2016-08.

606-10-55-36A

To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])

b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

606-10-55-37

An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

4.4.1 Identifying the specified good or service

Under ASC 606-10-55-36A, an entity must first identify the specified good or service (or unit of accounting for the principal versus agent evaluation) to be provided to the customer in the contract in order to determine the nature of its promise (i.e., whether it is to provide the specified goods or services or to arrange for those goods or services to be provided by another party). A specified good or service is defined in ASC 606-10-55-36 as each "distinct good or service (or distinct bundle of goods or services) to be provided to the customer." While this definition is similar to that of a performance obligation (see Section 4.2), the FASB noted in the Basis for Conclusions of ASU 2016-08[88] that it created this new term because using "performance obligation" would have been confusing in agency relationships. That is, because an agent's performance obligation is to arrange for goods or services to be provided by another party, providing the specified goods or services to the end customer is not the agent's performance obligation.

A specified good or service may be a distinct good or service or a distinct bundle of goods and services. The Board noted in the Basis for Conclusions of ASU 2016-08[89] that if individual goods or services are not distinct from one another, they may be inputs to a combined item and each good or service may represent only a part of a single promise to the customer. For example, in a contract in which goods or services provided by another party are inputs to a combined item(s), the entity should assess whether it controls the combined item(s) before that item(s) is transferred to the customer. That is, in determining whether it is a principal or an agent, an entity should evaluate that single promise to the customer rather than the individual inputs that make up that promise.

Appropriately identifying the good or service to be provided is a critical step in determining whether an entity is a principal or an agent in a transaction. In many situations, especially those involving tangible goods, identifying the specified good or service will be relatively straightforward. For example, if an entity is reselling laptop computers, the specified good that will be transferred to the customer is a laptop computer.

[88] Paragraph BC10 of ASU 2016-08.

[89] Paragraph BC29 of ASU 2016-08.

However, the assessment may require significant judgment in other situations, such as those involving intangible goods or services. In accordance with ASC 606-10-55-36A(a), the specified good or service may be the underlying good or service a customer ultimately wants to obtain (e.g., a flight, a meal) or a right to obtain that good or service (e.g., in the form of a ticket or voucher). The Board noted in the Basis for Conclusions of ASU 2016-08[90] that when the specified good or service is a right to a good or service that will be provided by another party, the entity would determine whether its performance obligation is a promise to provide that right (and it is therefore a principal) or whether it is arranging for the other party to provide that right (and it is therefore an agent). The fact that the entity will not provide the underlying goods or services itself is not determinative.

Because the Board acknowledged that it may be difficult in some cases to determine whether the specified good or service is the underlying good or service or a right to obtain that good or service, it provided examples in the standard. Example 47 (excerpted in full in Section 4.4.4) involves an airline ticket reseller. In this example, the entity pre-purchases airline tickets that it will sell later to customers. While the customer ultimately wants airline travel, the conclusion in Example 47 is that the specified good or service is the right to fly on a specified flight (in the form of a ticket), and not the underlying flight itself. In reaching that conclusion, the Board noted[91] that the entity itself does not fly the plane, and it cannot change the service (e.g., change the flight time or destination). However, the entity obtained the ticket prior to identifying a specific customer to purchase the ticket. As such, the entity holds an asset (in the form of a ticket) that represents a right to fly. The entity could then transfer that right to a customer (as depicted in the example) or decide to use the right itself.

Example 46A (excerpted in full in Section 4.4.4) involves an office maintenance service provider. In this example, the entity concludes that the specified good or service is the underlying office maintenance service (rather than a right to that service). In reaching that conclusion, the Board noted[92] that, while the entity obtained the contract with the customer prior to engaging a third party to perform the requested services, the right to the subcontractor's services is never transferred to the customer. Instead, the entity retains the right to direct the service provider. That is, the entity can direct the right to use the subcontractor's services as it chooses (e.g., to fulfill the customer contract, to fulfill another customer contract, to service its own facilities). Further, the Board noted that the customer in Example 46A is indifferent as to who carries out the office maintenance services. That is not the case in Example 47 where the customer wants the ticket reseller to sell one of its tickets on a specific flight.

If a contract with a customer includes more than one specified good or service, ASC 606-10-55-36 clarifies that an entity may be a principal for some specified goods or services and an agent for others. Example 48A (excerpted in full in Section 4.4.4) provides an illustration of this.

How we see it

As discussed above, appropriately identifying the specified good or service to be provided to the customer is a critical step in identifying whether the nature of an entity's promise is to act as a principal or an agent. Entities may need to apply significant judgment to determine whether the specified good or service is the underlying good or service or a right to obtain that good or service.

[90] Paragraph BC25 of ASU 2016-08.

[91] Paragraph BC27 of ASU 2016-08.

[92] Paragraph BC28 of ASU 2016-08.

4.4.2 Control of the specified good or service

Under ASC 606-10-55-36A, the second step in determining the nature of the entity's promise (i.e., whether it is to provide the specified goods or services or to arrange for those goods or services to be provided by another party) is for the entity to determine whether the entity controls the specified good or service before it is transferred to the customer. An entity cannot provide the specified good or service to a customer (and therefore be a principal) unless it controls that good or service prior to its transfer. That is, as the Board noted in the Basis for Conclusions of ASU 2016-08,[93] control is the determining factor when assessing whether an entity is a principal or an agent.

In assessing whether an entity controls the specified good or service prior to transfer to the customer, ASC 606-10-55-36A(b) requires the entity to consider the definition of control included in Step 5 of the model under ASC 606-10-25-25 (included below and further discussed in Chapter 7):

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Satisfaction of Performance Obligations

606-10-25-25

Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

a. Using the asset to produce goods or provide services (including public services)

b. Using the asset to enhance the value of other assets

c. Using the asset to settle liabilities or reduce expenses

d. Selling or exchanging the asset

e. Pledging the asset to secure a loan

f. Holding the asset.

If, after evaluating the guidance in ASC 606-10-25-25, an entity concludes that it controls the specified good or service before transfer to the customer, the entity is a principal in the transaction. If the entity does not control that good or service before transfer to the customer, it is an agent.

Stakeholder feedback indicated that the control principle was easier to apply to tangible goods than to intangible goods and services because intangible goods and services generally exist only at the moment they are delivered. To address this concern, the standard includes guidance on how the control principle applies to certain types of arrangements (including service transactions) by explaining what a principal controls before the specified good or service is transferred to the customer:

[93] Paragraph BC31 of ASU 2016-08.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Principal versus Agent Considerations

606-10-55-37A

When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.

b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.

c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

The Board observed in the Basis for Conclusions of ASU 2016-08[94] that an entity can control a service to be provided by another party when it controls the right to the specified service that will be provided to the customer. Generally, the entity will then either transfer the right (in the form of an asset such as a ticket) to its customer in accordance with ASC 606-10-55-37A(a) (as in Example 47 involving the airline ticket reseller discussed in Section 4.4.1) or use its right to direct the other party to provide the specified service to the customer on the entity's behalf in accordance with ASC 606-10-55-37A(b) (as in Example 46A involving the office maintenance services discussed in Section 4.4.1).

The condition described in ASC 606-10-55-37A(a) would include contracts in which an entity transfers to the customer a right to a future service to be provided by another party. If the specified good or service is a right to a good or service to be provided by another party, the entity evaluates whether it controls the right to the goods or services before that right is transferred to the customer (rather than whether it controls the underlying goods or services). In doing so, the Board noted in the Basis for Conclusions of ASU 2016-08[95] that it is often relevant to assess whether the right is created only when it is obtained by the customer or whether the right exists before the customer obtains it. If the right does not exist before the customer obtains it, an entity would be unable to control it before its transfer to the customer.

The standard includes two examples to illustrate this point. In Example 47 (discussed above in Section 4.4.1 and excerpted in full in Section 4.4.4) involving an airline ticket reseller, the specified good or service is determined to be the right to fly on a specified flight (in the form of a ticket). One of the determining factors for the principal-agent evaluation in this example is that the entity pre-purchases the airline tickets before a specific customer is identified. Accordingly, the right existed prior to a customer obtaining it. The example concludes that the entity controls the right before it is transferred to the customer (and is therefore a principal).

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[94] Paragraph BC34 of ASU 2016-08.

[95] Paragraph BC25 of ASU 2016-08.

In Example 48 (excerpted in full in Section 4.4.4), an entity sells vouchers that entitle customers to future meals at specified restaurants selected by the customer, and the specified good or service is determined to be the right to a meal (in the form of a voucher). One of the determining factors for the principal-agent evaluation is that the entity does not control the voucher (right to a meal) at any time. It does not pre-purchase or commit itself to purchase the vouchers from the restaurants before they are sold to a customer. Instead, the entity waits to purchase the voucher until a voucher for a particular restaurant is requested by a customer. In addition, vouchers are created only at the time that they are transferred to a customer and do not exist before that transfer. Accordingly, the right does not exist before the customer obtains it. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers. The example concludes that the entity does not control the right before it is transferred to the customer (and is therefore an agent).

In the Basis for Conclusions of ASU 2016-08,[96] the FASB acknowledged that determining whether an entity is a principal or an agent may be more difficult when evaluating whether a contract falls under ASC 606-10-55-37A(b). That is, it might be difficult to determine whether an entity has the ability to direct another party to provide the service on its behalf (and is therefore a principal) or is only arranging for the other party to provide the service (and is therefore an agent). As depicted in Example 46A (as discussed in Section 4.4.1 and excerpted in full in Section 4.4.4), an entity could control the right to the specified service and be a principal by entering into a contract with the subcontractor in which the entity defines the scope of service to be performed by the subcontractor on its behalf. This situation is equivalent to the entity fulfilling the contract using its own resources, and the entity would remain responsible for the satisfactory provision of the specified service in accordance with the contract with the customer. In contrast, when the specified service is provided by another party and the entity does not have the ability to direct those services, the entity would typically be an agent because the entity would be facilitating, rather than controlling the rights to, the service.

In accordance with ASC 606-10-55-37A(c), if an entity provides a significant service of integrating two or more goods or services into a combined item that is the specified good or service the customer contracted to receive, the entity controls that specified good or service before it is transferred to the customer. This is because the entity first obtains controls of the inputs to the specified good or service, which can include goods or services from other parties, and directs their use to create the combined item that is the specified good or service. The inputs would be a fulfillment cost to the entity. However, as noted by the Board in the Basis for Conclusions of ASU 2016-08,[97] if a third party provides the significant integration service, the entity's customer for its good or services (which would be inputs to the specified good or service) is likely to be the third party.

4.4.2.1 Principal indicators

Because it still may not be clear whether an entity controls the specified good or service after considering the guidance discussed above, the standard provides three indicators of when an entity controls the specified good or service and is therefore a principal:

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[96] Paragraph BC35 of ASU 2016-08.

[97] Paragraph BC30 of ASU 2016-08.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Principal versus Agent Considerations

606-10-55-39

Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

606-10-55-39A

The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

The above indicators are meant to support an entity's assessment of control, not to replace it, and each indicator explains how it supports the assessment of control. As emphasized in the Basis for Conclusions of ASU 2016-08,[98] the indicators do not override the assessment of control, should not be viewed in isolation, do not constitute a separate or additional evaluation, and should not be considered a checklist of criteria to be met in all scenarios. ASC 606-10-55-39A highlights that considering one or more of the indicators often will be helpful, and, depending on the facts and circumstances, individual indicators will be more or less relevant or persuasive to the assessment of control.

The first indicator that an entity is a principal, in ASC 606-10-55-39(a), is that the entity is primarily responsible for both fulfilling the promise to provide the specified good or service to the customer and for the acceptability of the specified good or service. We believe one of the ways that this indicator supports the assessment of control of the specified good or service is because an entity generally will control a specified good or service that it is responsible for transferring to a customer.

[98] Paragraph BC16 of ASU 2016-08.

The terms of the contract and representations (written or otherwise) made by an entity during marketing generally will provide evidence as to which party is responsible for fulfilling the promise to provide the specified good or service and for the acceptability of that good or service.

It is possible that one entity may not be solely responsible for both providing the specified good or service and for the acceptability of that same good or service. For example, a reseller may sell goods or services that are provided to the customer by a supplier. However, if the customer is dissatisfied with the goods or services it receives, the reseller may be solely responsible for providing a remedy to the customer. The reseller may promote such a role during the marketing process, or may agree to such a role as claims arise to maintain its relationship with its customer. In this situation, both the reseller and the supplier possess characteristics of this indicator and other indicators will likely need to be considered to determine which entity is the principal. However, if the reseller is responsible for providing a remedy to a dissatisfied customer but can then pursue a claim against the supplier to recoup any remedies it provides, that may indicate that the reseller is not ultimately responsible for the acceptability of the specified good or service.

The second indicator that an entity is a principal, in ASC 606-10-55-39(b), is that the entity has inventory risk (before the specified good or service is transferred to the customer or upon customer return). Inventory risk is the risk normally taken by an entity that acquires inventory in hopes of reselling it at a profit. Inventory risk exists if a reseller obtains (or commits to obtain) the specific good or service before that specified good or service is ordered by a customer. Inventory risk also exists if a customer has a right of return and the reseller will take back the specified good service if the customer exercises this right.

This indicator supports the assessment of control of the specified good or service because when an entity obtains (or commits to obtain) the specified good or service before it has contracted with a customer, it likely has the ability to direct the use of, and obtain substantially all of the remaining benefits from the good or service. For example, inventory risk can exist in a customer arrangement involving the provision of services if an entity is obligated to compensate the individual service provider(s) for work performed, regardless of whether the customer accepts that work. However, this indicator will often not apply for intangible goods and services.

Factors may exist that mitigate a reseller's inventory risk. For example, a reseller's inventory risk may be significantly reduced or eliminated if it has the right to return to the supplier goods it cannot sell or goods that are returned by customers or if it receives inventory price protection from the supplier. In these cases, the inventory risk indicator may be less relevant or persuasive to the assessment of control.

The third principal indicator, in ASC 606-10-55-39(c), is that the entity has discretion in establishing the price of the specified good or service. Reasonable latitude, within economic constraints, to establish the price with a customer for the product or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits (i.e., the entity controls the specified good or service). However, because an agent also may have discretion in establishing the price of the specified good or service, the facts and circumstances of the transaction will need to be carefully evaluated.

How we see it

The three indicators in ASC 606-10-55-39 are similar to some of those included in the legacy principal versus agent guidance in ASC 605-45, but they are based on the concepts of identifying performance obligations and the transfer of control of goods and services. In addition, the new standard does not carry forward from ASC 605-45 several other indicators (e.g., those relating to the form of the consideration as a commission and exposure to credit risk) or the concept of stronger and weaker indicators.

Accordingly, the FASB acknowledged in the Basis for Conclusions of ASU 2016-08[99] that entities could reach different conclusions under the new guidance than they did under ASC 605-45. The Deputy Chief Accountant of the SEC's Office of the Chief Accountant also noted in a speech[100] that entities should not assume that their legacy principal versus agent conclusions will remain unchanged under the amended guidance. Entities will likely need to take a fresh look at their principal versus agent conclusions under the new guidance.

4.4.3 Recognizing revenue as a principal or agent

The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognizes as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Principal versus Agent Considerations

606-10-55-37B

When (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes **revenue** in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

606-10-55-38

An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

That is, when the entity is the principal in the arrangement, the revenue recognized is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognized is the net amount the entity is entitled to retain in return for its services as the agent. The entity's fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

After an entity determines whether it is the principal or the agent and the amount of gross or net revenue that should be recognized, the entity recognizes revenue when or as it satisfies its performance obligation. An entity satisfies its performance obligation by transferring control of the specified good or service underlying the performance obligation either at a point in time or over time (as discussed in Chapter 7).

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[99] Paragraph BC17 of ASU 2016-08.

[100] Speech by Wesley R. Bricker, 9 June 2016. Refer to SEC website at https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html.

In some contracts in which the entity is the agent, the Board noted in the Basis for Conclusions of ASU 2014-09[101] that control of specified goods or services promised by the agent might transfer before the customer receives related goods or services from the principal. For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

- The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.
- The points entitle the customers to future discounted purchases with another party (i.e., the points represent a material right to a future discount).
- The entity determines that it is an agent (i.e., its promise is to arrange for the customers to be provided with points), and the entity does not control those points (i.e., the specified good or service) before they are transferred to the customer.

In contrast, if the points entitle the customers to future goods or services to be provided by the entity, the entity may conclude it is not an agent. This is because the entity's promise is to provide those future goods or services and, thus, the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation may only be satisfied when the future goods or services are provided.

In other cases, the points may entitle customers to choose between future goods or services provided by either the entity or another party. In this situation, the nature of the entity's performance obligation may not be known until the customer makes its choice. That is, until the customer has chosen the goods or services to be provided (and thus whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Thus, the entity may not satisfy its performance obligation until it either delivers the goods or services or is no longer obliged to stand ready. If the customer subsequently chooses to receive the goods or services from another party, the entity would need to consider whether it was acting as an agent and thus should recognize revenue for only a fee or commission that it received for arranging the ultimate transaction between the customer and the third party.

How we see it

This discussion illustrates that control of specified goods or services promised by an agent might transfer before the customer receives related goods or services from the principal. An entity will need to assess each loyalty program in accordance with the principles of the principal versus agent guidance to determine if revenue should be reported on a gross or net basis.

[101] Paragraphs BC383 through BC385 of ASU 2014-09.

In addition, although an entity may be able to transfer its obligation to provide its customer specified goods or services, the standard says that such a transfer may not always satisfy the performance obligation:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Principal versus Agent Considerations

606-10-55-40

If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (that is, the entity is no longer acting as the principal), the entity should not recognize revenue for that performance obligation. Instead, the entity should evaluate whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether the entity is acting as an agent).

4.4.4 Examples

The standard includes six examples to illustrate the principal versus agent guidance discussed above. We have excerpted four of them below.

The standard includes the following example of when the specified good or service (see Section 4.4.1) is the underlying service, rather than the right to obtain that service. The entity in this example is determined to be a principal:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 46A — Promise to Provide Goods or Services (Entity Is a Principal)

606-10-55-324A

An entity enters into a contract with a customer to provide office maintenance services. The entity and the customer define and agree on the scope of the services and negotiate the price. The entity is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract. The entity invoices the customer for the agreed-upon price on a monthly basis with 10-day payment terms.

606-10-55-324B

The entity regularly engages third-party service providers to provide office maintenance services to its customers. When the entity obtains a contract from a customer, the entity enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer. The payment terms in the contracts with the service providers generally are aligned with the payment terms in the entity's contracts with customers. However, the entity is obliged to pay the service provider even if the customer fails to pay.

606-10-55-324C

To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

606-10-55-324D

The entity observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted and that no other goods or services are promised to the customer. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that the entity has not agreed to provide. Therefore, the right to office maintenance services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.

606-10-55-324E

The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph 606-10-55-37A(b)). In addition, the entity concludes that the following indicators in paragraph 606-10-55-39 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:

a. The entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (that is, the entity is responsible for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).

b. The entity has discretion in setting the price for the services to the customer.

606-10-55-324F

The entity observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Thus, the entity has mitigated its inventory risk with respect to the office maintenance services. Nonetheless, the entity concludes that it controls the office maintenance services before they are provided to the customer on the basis of the evidence in paragraph 606-10-55-324E.

606-10-55-324G

Thus, the entity is a principal in the transaction and recognizes revenue in the amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

The standard also includes the following example of when the specified good or service is the right to obtain a service and not the underlying service itself. The entity in this example is determined to be a principal:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 47 — Promise to Provide Goods or Services (Entity is a Principal)

606-10-55-325

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance.

606-10-55-326

The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased.

606-10-55-327

The entity also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

606-10-55-328

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

606-10-55-328A

The entity concludes that with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers (see paragraph 606-10-55-37A(a)). Consequently, the entity determines that the specified good or service to be provided to its customer is that right (to a seat on a specific flight) that the entity controls. The entity observes that no other goods or services are promised to the customer.

606-10-55-328B

The entity controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and, if so, which contract it will fulfill. The entity also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

606-10-55-328C

The indicators in paragraph 606-10-55-39(b) through (c) also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer. The entity has inventory risk with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favorable price for the ticket. The entity also establishes the price that the customer will pay for the specified ticket.

606-10-55-329

Thus, the entity concludes that it is a principal in the transactions with customers. The entity recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

In the following example, the entity also determines that the specified good or service is the right to obtain a service and not the underlying service itself. However, the entity in this example is determined to be an agent.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 48 — Arranging for the Provision of Goods or Services (Entity is an Agent)

606-10-55-330

An entity sells vouchers that entitle customers to future meals at specified restaurants, and the sales price of the voucher provides the customer with a significant discount when compared with the normal selling prices of the meals (for example, a customer pays $100 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost $200). The entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only as they are requested by the customers. The entity sells the vouchers through its website, and the vouchers are nonrefundable.

606-10-55-331

The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers. Under the terms of its contracts with the restaurants, the entity is entitled to 30 percent of the voucher price when it sells the voucher.

606-10-55-332

The entity also assists the customers in resolving complaints about the meals and has a buyer satisfaction program. However, the restaurant is responsible for fulfilling obligations associated with the voucher, including remedies to a customer for dissatisfaction with the service.

606-10-55-333

To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls the specified good or service before that good or service is transferred to the customer.

606-10-55-333A

A customer obtains a voucher for the restaurant that it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf as described in the indicator in paragraph 606-10-55-39(a). Therefore, the entity observes that the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant or restaurants, which the customer purchases and then can use itself or transfer to another person. The entity also observes that no other goods or services (other than the vouchers) are promised to the customers.

606-10-55-333B

The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:

a. The vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers.

b. The entity neither purchases nor commits itself to purchase vouchers before they are sold to customers. The entity also has no responsibility to accept any returned vouchers. Therefore, the entity does not have inventory risk with respect to the vouchers as described in the indicator in paragraph 606-10-55-39(b).

606-10-55-334

Thus, the entity concludes that it is an agent in the arrangement with respect to the vouchers. The entity recognizes revenue in the net amount of consideration to which the entity will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 30 percent commission it is entitled to upon the sale of each voucher.

ASC 606-10-55-36 clarifies that an entity may be a principal for some specified goods or services in a contract and an agent for others. The standard includes the following example of a contract in which an entity is both a principal and an agent:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 48A — Entity Is a Principal and an Agent in the Same Contract

606-10-55-334A

An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, such as interviewing candidates and performing background checks. As part of the contract with a customer, the customer agrees to obtain a license to access a third party's database of information on potential recruits. The entity arranges for this license with the third party, but the customer contracts directly with the database provider for the license. The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer. The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service down-time or other technical issues.

606-10-55-334B

To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer and assesses whether it controls those goods or services before they are transferred to the customer.

606-10-55-334C

For the purpose of this Example, it is assumed that the entity concludes that its recruitment services and the database access license are each distinct on the basis of its assessment of the guidance in paragraphs 606-10-25-19 through 25-22. Accordingly, there are two specified goods or services to be provided to the customer—access to the third-party's database and recruitment services.

606-10-55-334D

The entity concludes that it does not control the access to the database before it is provided to the customer. The entity does not at any time have the ability to direct the use of the license because the customer contracts for the license directly with the database provider. The entity does not control access to the provider's database—it cannot, for example, grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

606-10-55-334E

As part of reaching that conclusion, the entity also considers the indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer:

a. The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).

b. The entity does not have inventory risk because it does not purchase or commit to purchase the database access before the customer contracts for database access directly with the database provider.

c. The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

606-10-55-334F

Thus, the entity concludes that it is an agent in relation to the third-party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer.

Question 4-8 **How should entities determine the presentation of amounts billed to customers (e.g., shipping and handling, reimbursement of out-of-pocket expenses, taxes or other assessments) under the standard (i.e., as revenue or as a reduction of costs)?** [18 July 2014 TRG meeting; TRG agenda paper no. 2]

TRG members generally agreed that the standard is clear that any amounts collected on behalf of third parties should not be included in the transaction price (i.e., revenue). As discussed in Chapter 5, ASC 606-10-32-2 says, "The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)." That is, if the amounts were incurred by the entity in fulfilling its performance obligations, the amounts should be included in the transaction price and recorded as revenue.

Further, TRG members generally agreed that an entity should apply the principal versus agent guidance when it is not clear whether the amounts are collected on behalf of third parties. This could result in amounts billed to a customer being recorded as an offset to costs incurred.

However, several TRG members noted that this conclusion would require entities to evaluate taxes collected in all jurisdictions in which they operate to determine whether a tax is levied on the entity or the customer. In response, as discussed in Section 5.1, the FASB amended the standard to allow an entity to make an accounting policy election to exclude from the transaction price (i.e., present revenue net of) certain types of taxes collected from a customer, including sales, use, value-added and some excise taxes. As a result, entities will not need to evaluate taxes they collect in all jurisdictions in which they operate to determine whether a tax is levied on the entity or the customer.

Question 4-9 **Should an entity that is a principal estimate its gross transaction price when it does not know (and expects not to know) the price charged to its customer for its goods and services by an intermediary?**

No, an entity that is a principal should not estimate its gross transaction price when it does not know (and expects not to know) the price charged to its customer for its goods and services by an intermediary. The Board stated in the Basis for Conclusions of ASU 2016-08[102] that if uncertainty related to the transaction price is not ultimately expected to be resolved, it would not meet the definition of variable consideration and therefore should not be included in the transaction price.

[102] Paragraph BC38 of ASU 2016-08.

How we see it

Stakeholder outreach on this question indicated that under legacy revenue guidance, some entities estimate the price charged to the customer by the intermediary and recognize that amount as their revenue, while others recognize only the amount to which they are entitled from the intermediary. The Board's conclusion on this question will change practice for entities that estimated their gross revenue in these situations.

IASB differences

The IASB did not specifically consider how the transaction price requirements would be applied in these situations (i.e., when an entity that is a principal does not know and expects not to know the price charged to its customer by an agent), but concluded in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that an entity that is a principal would generally be able to apply judgment and determine the consideration to which it is entitled using all information available to it. Accordingly, we believe that it is possible that US GAAP and IFRS entities will reach different conclusions on estimating the gross transaction price in these situations.

4.5 Consignment arrangements

The standard provides specific guidance for a promise to deliver goods on a consignment basis to other parties. See Section 7.4.

4.6 Customer options for additional goods or services

Many sales contracts give customers the option to acquire additional goods or services. These additional goods and services may be priced at a discount or may even be free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives, volume-tiered pricing structures, customer award credits (e.g., frequent flyer points) or contract renewal options (e.g., waiver of certain fees, reduced future rates).

The standard provides the following guidance on customer options:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance

Customer Options for Additional Goods or Services

606-10-55-41

Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services.

606-10-55-42

If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

606-10-55-43

If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.

As stated above, when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation only if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). The Board indicated in the Basis for Conclusions of ASU 2014-09[103] that the purpose of this guidance is to identify and account for options that customers are paying for (often implicitly) as part of the current transaction. The FASB did not provide any bright lines about what constitutes a "material" right. However, the guidance states that if the discounted price the customer would receive by exercising the option reflects the standalone selling price that a customer without an existing relationship with the entity would pay, the option doesn't provide a material right, and the entity is deemed to have made a marketing offer.

How we see it

Significant judgment may be required to determine whether a customer option represents a material right. This determination is important because it will affect the accounting and disclosures for the contract at inception and throughout the life of the contract.

Legacy GAAP for software revenue recognition (ASC 985-605) includes guidance on distinguishing between an option and a marketing offer, and this guidance is often applied by analogy to other arrangements, including multiple-element arrangements. While the principles underlying the new guidance on determining whether an option represents a material right in a contract are similar to the principles underlying the guidance in ASC 985-605, the new guidance is not the same as legacy GAAP. The new guidance also will broadly apply to all contracts within the scope of ASC 606. Accordingly, entities will need to carefully evaluate how the new guidance will affect their transactions. Entities that have not followed the guidance in ASC 985-605 likely will see a change in their accounting, and even entities that have followed ASC 985-605 may need to change how they identify and/or measure options for additional goods or services that represent a material right.

The standard includes the following example to illustrate the determination of whether an option represents a material right (see Section 6.1.5 for a discussion of the measurement of options that are separate performance obligations):

[103] Paragraph BC386 of ASU 2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 49 — Option That Provides the Customer with a Material Right (Discount Voucher)

606-10-55-336

An entity enters into a contract for the sale of Product A for $100. As part of the contract, the entity gives the customer a 40 percent discount voucher for any future purchases up to $100 in the next 30 days. The entity intends to offer a 10 percent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 percent discount cannot be used in addition to the 40 percent discount voucher.

606-10-55-337

Because all customers will receive a 10 percent discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10 percent (that is, the additional 30 percent discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

606-10-55-338

To estimate the standalone selling price of the discount voucher in accordance with paragraph 606-10-55-44, the entity estimates an 80 percent likelihood that a customer will redeem the voucher and that a customer will, on average, purchase $50 of additional products. Consequently, the entity's estimated standalone selling price of the discount voucher is $12 ($50 average purchase price of additional products × 30 percent incremental discount × 80 percent likelihood of exercising the option). The standalone selling prices of Product A and the discount voucher and the resulting allocation of the $100 transaction price are as follows:

Performance obligation	**Standalone selling price**
Product A	$ 100
Discount voucher	12
Total	$ 112

Performance obligation	**Allocated transaction price**	
Product A	$ 89	($100 ÷ $112 × $100)
Discount voucher	11	($12 ÷ $112 × $100)
Total	$ 100	

606-10-55-339

The entity allocates $89 to Product A and recognizes revenue for Product A when control transfers. The entity allocates $11 to the discount voucher and recognizes revenue for the voucher when the customer redeems it for goods or services or when it expires.

Question 4-10 **Should entities consider only the current transaction or should they consider past and future transactions with the same customer when determining whether an option for additional goods and services provides the customer with a material right?** [31 October 2014 TRG meeting; agenda paper no. 6]

TRG members generally agreed that entities should consider all relevant transactions with a customer (i.e., current, past and future transactions), including those that provide accumulating incentives such as loyalty programs, when determining whether an option represents a material right. That is, the evaluation should not be performed only in relation to the current transaction.

Question 4-11 **Is the material right evaluation solely a quantitative evaluation or should the evaluation also consider qualitative factors?** [31 October 2014 TRG meeting; agenda paper no. 6]

TRG members generally agreed that the evaluation should consider both quantitative and qualitative factors (e.g., what a new customer would pay for the same service, the availability and pricing of competitors' service alternatives, whether the average customer life indicates that the fee provides an incentive for customers to remain beyond the stated contract term, whether the right accumulates) because a customer's perspective on what constitutes a "material right" might consider qualitative factors. This is consistent with the notion that when identifying promised goods or services in Step 2, an entity should consider reasonable expectations of the customer that the entity will transfer a good or service to it.

Question 4-12 **How should an entity distinguish between a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration (see Section 5.2) based on a variable quantity (e.g., a usage-based fee)?** [9 November 2015 TRG meeting; agenda paper no. 48]

TRG members generally agreed that this determination requires judgment and consideration of the facts and circumstances. They also generally agreed that the TRG agenda paper on this question provides a framework that will help entities make this determination.

This determination is important because it will affect the accounting for the contract at inception and throughout the life of the contract as well as disclosures. If an entity concludes that a customer option for additional goods or services provides a material right, the option itself is deemed to be a performance obligation in the contract, but the underlying goods or services are not until the option is exercised (as discussed below in Question 4-13). As a result, the entity will be required to allocate a portion of the transaction price to the material right at contract inception and to recognize that revenue when or as the option is exercised or the option expires. If an entity instead concludes that an option for additional goods or services is not a material right, there is no accounting for the option and no accounting for the underlying optional goods or services until those subsequent purchases occur.

However, if the contract includes variable consideration (rather than a customer option), an entity will have to estimate at contract inception the variable consideration expected over the life of the contract and update that estimate each reporting period (subject to a constraint) (see Section 5.2). There are also more disclosures required for variable consideration (e.g., the requirement to disclose the remaining transaction price for unsatisfied performance obligations) (see Section10.4.1) than for options that are not determined to be material rights.

The TRG agenda paper explained that the first step in determining whether a contract involving variable quantities of goods or services should be accounted for as a contract containing customer options or variable consideration is for the entity to determine the nature of its promise in providing goods or services to the customer and the rights and obligations of the parties.

In a contract in which the variable quantity of goods or services results in variable consideration, the nature of the entity's promise is to transfer to the customer an overall service. In providing this overall service, an entity may perform individual tasks or activities. At contract inception, the entity is presently obligated by the terms and conditions of the contract to transfer all promised goods or services provided under the contract, and the customer is obligated to pay for those promised goods or services. The customer's subsequent actions to utilize the service affect the measurement of revenue (in the form of variable consideration).

For example, consider a contract between a transaction processor and a customer in which the processor will process all of the customer's transactions in exchange for a fee paid for each transaction processed. The ultimate quantity of transactions that will be processed is not known. The nature of the entity's promise is to provide the customer with continuous access to the processing platform so that submitted transactions are processed. By entering into the contract, the customer has made a purchasing decision that obligates the entity to provide continuous access to the transaction processing platform. The consideration paid by the customer results from events (i.e., additional transactions being submitted for processing to the processor) that occur after (or as) the entity transfers the payment processing service. The customer's actions do not obligate the processor to provide additional distinct goods or services because the processor is already obligated (starting at contract inception) to process all transactions submitted to it.

Another example described in the TRG agenda paper of contracts that may include variable consideration include certain information technology outsourcing contracts. Under this type of contract (similar to the transaction processing contract discussed above), the vendor provides continuous delivery of a service over the contract term and the amount of service provided is variable.

In contrast, with a customer option, the nature of the entity's promise is to provide the quantity of goods or services specified in the contract. The entity is *not obligated* to provide additional distinct goods or services *until* the customer exercises the option. The customer has a contractual right that allows it to choose the amount of additional distinct goods or services to purchase, but the customer has to make a separate purchasing decision to obtain those additional distinct goods or services. Prior to the customer's exercise of that right, the entity is not obligated to provide (nor does it have a right to consideration for transferring) those goods or services.

The TRG agenda paper included the following example of a contract that includes a customer option (rather than variable consideration): Entity B enters into a contract to provide 100 widgets to Customer Y at $10 per widget. Each widget is a distinct good transferred at a point in time. The contract also gives Customer Y the right to purchase additional widgets at the standalone selling price of $10 per widget. Therefore, the quantity that may be purchased by Customer Y is variable.

The conclusion in the TRG agenda paper was that, while the quantity of widgets that may be purchased is variable, the transaction price for the existing contract is fixed at $1,000 [100 widgets x $10/widget]. That is, the transaction price only includes the consideration for the 100 widgets specified in the contract, and the customer's decision to purchase additional widgets is an option. While Entity B may be required to deliver additional widgets in the future, Entity B is not legally obligated to provide the additional widgets until Customer Y exercises the option. In this example, the option is accounted for as a separate contract because there is no material right, given the pricing of the option at the standalone selling price of the widget.

The TRG agenda paper also included the following example of a contract in which the variable quantity of goods or services includes a customer option:

Example of customer option

A supplier enters into a five-year MSA in which the supplier is obligated to produce and sell parts to a customer at the customer's request. That is, the supplier is not obligated to transfer any parts until the customer submits a purchase order. In addition, the customer is not obligated to purchase any parts; however, it is highly likely it will because the part is required to manufacture the customer's product and it is not practical to get parts from multiple suppliers. Each part is determined to a distinct good that transfers to the customer at a point in time.

The conclusion in the TRG agenda paper is that the nature of the promise in this example is the delivery of parts (and not a service of standing ready to produce and sell parts). That is, the contract provides a right to the customer to choose the quantity of additional distinct goods (i.e., provides a customer option) versus a right to use the services for which control to the customer has (or is currently being) transferred (such as in the transaction processor example above). Similarly, the supplier is not obligated to transfer any parts until the customer submits the purchase order (another important factor in distinguishing a customer option from variable consideration), while in the other fact patterns the vendor is obligated to make the promised services available to the customer without any additional decisions made by the customer.

The TRG agenda paper contrasted this example with other contracts that may include a stand-ready obligation (e.g., a customer's use of a health club). When the customer submits a purchase order under the MSA, it is contracting for a specific number of distinct goods, which creates new performance obligations for the supplier. In contrast, a customer using services in a health club is using services that the health club is already obligated to provide under the present contract. That is, there are no new obligations arising from the customer's usage.

The TRG agenda paper also included the following example of a contract in which the variable quantity of goods or services results in variable consideration:

Example of variable consideration

Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges Customer X based on its usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. Customer X is not contractually obligated to use the equipment; however, Entity A is contractually obligated to transfer the equipment to Customer X.

The conclusion in the TRG agenda paper was that the usage of the equipment by Customer X is a variable quantity that affects the amount of consideration owed to Entity A. It does not affect Entity A's performance obligation, which is to transfer the piece of equipment. That is, Entity A has performed by transferring the distinct good, and Customer X's actions that result in payment to Entity A occur after the equipment has been transferred and do not require Entity A to provide additional goods or services.

Question 4-13 **When, if ever, should an entity consider the goods or services underlying a customer option as a separate performance obligation?** [9 November 2015 TRG meeting; agenda paper no. 48]

If there are no contractual penalties (e.g., termination fees, monetary penalties for not meeting contractual minimums), TRG members generally agreed that, even if an entity may think that it is virtually certain (e.g., the customer is economically compelled) that a customer will exercise its option for additional goods and services, the entity should not identify the additional goods and services underlying the option as promised goods or services (or performance obligations) at contract inception. Only the option should be assessed to determine whether it represents a material right to be accounted for as a performance obligation. As a result, consideration that would be received for optional goods or services should not be included in the transaction price at contract inception.

The TRG agenda paper included the following example of a contract in which it is virtually certain that a customer will exercise its option for additional goods and services:

Example of customer option with no contractual penalties

An entity sells equipment and consumables, both of which are determined to be distinct goods that are recognized at a point in time. The standalone selling price of the equipment and each consumable is $10,000 and $100, respectively. The equipment costs $8,000, and each consumable costs $60. The entity sells the equipment for $6,000 (40% discount from its standalone selling price) with a customer option to purchase each consumable for $100 (equal to its standalone selling price). There are no contractual minimums, but the entity estimates the customer will purchase 200 consumables over the next two years. This is an exclusive contract, and the customer cannot purchase the consumables from any other vendors during the contract term.

TRG members generally agreed that the consumables underlying each option would not be considered a part of the initial contract, and the option itself does not represent a material right because it is priced at the standalone selling price for the consumable. This is the case even though the customer is compelled to exercise its option for the consumables because the equipment cannot function without the consumables and the contract includes an exclusivity clause that requires the customer to acquire the consumables only from the entity. Accordingly, the transaction price is $6,000, and it is entirely attributable to the equipment resulting in a loss for the entity of $2,000 when the entity transfers control of the equipment to the customer.

If contractual penalties exist (e.g., termination fees, monetary penalties assessed for not meeting contractual minimums), the entity will need to further analyze the goods or services underlying customer options to determine which ones should be accounted for in the present contract. If there are substantive contractual penalties, it may be appropriate to include some or all of the goods or services underlying customer options as part of the contract at inception because the penalty effectively creates a minimum purchase obligation for the goods or services that would be purchased if the penalty were enforced.

Example of customer option with contractual penalties

Consider the same facts as in the example above except that the customer will incur a penalty if it does not purchase at least 200 consumables. That is, the customer will be required to repay some or all of the $4,000 discount provided on the equipment. Per the contract terms, the penalty decreases as each consumable is purchased at a rate of $20 per consumable.

The conclusion in the TRG agenda paper was that the penalty is substantive and it effectively creates a minimum purchase obligation. As a result, the entity would conclude that the minimum number of consumables required to avoid the penalty would be evidence of enforceable rights and obligations. The entity would then calculate the transaction price as $26,000 [(200 consumables x $100/consumable) + $6,000 (the selling price of the equipment)]. Further, the conclusion in the TRG agenda paper was that, if the customer failed to purchase 200 consumables, the entity would account for the resulting penalty as a contract modification.

Question 4-14 **Should volume rebates and/or discounts on goods or services be accounted for as variable consideration or as customer options to acquire additional goods or services at a discount?**

It will depend on whether rebate or discount program is applied retrospectively or prospectively.

Generally, if a volume rebate or discount is applied prospectively, we believe the rebate or discount would be accounted for as a customer option (not variable consideration). This is because the consideration for the goods or services in the present contract is not contingent upon or affected by any future purchases. Rather, the discounts available from the rebate program affect the price of future purchases. Entities will need to evaluate whether the volume rebate or discount provides the customer with an option to purchase goods or services in the future at a discount that represents a material right (and is therefore accounted for as a performance obligation) (see Question 4-15 below).

However, we believe a volume rebate or discount that is applied retrospectively will be accounted for as variable consideration (see Section 5.2). This is because the final price of each good or service sold depends on the customer's total purchases subject to the rebate program. That is, the consideration is contingent upon the occurrence or nonoccurrence of future events. This view is consistent with Example 24 in the standard (which is excerpted in full in Section 5.2.1).

Entities should keep in mind that they will need to evaluate whether contract terms other than those specific to the rebate or discount program create variable consideration that would need to be separately evaluated (e.g., if the goods subject to the rebate program are also sold with a right of return).

Question 4-15 **How should an entity consider whether prospective volume discounts determined to be customer options are material rights?** [18 April 2016 FASB TRG meeting; agenda paper no. 54]

FASB TRG members generally agreed that in making this evaluation, an entity should first evaluate whether the option exists independently of the existing contract. That is, would the entity offer the same pricing to a similar high-volume customer independent of a prior contract with the entity? If yes, that will indicate that the volume discount is not a material right as it is not incremental to the discount typically offered to a similar high-volume customer. If the entity would typically charge a higher price to a similar customer that might indicate that the volume discount is a material right as the discount is incremental.

The TRG agenda paper included the following example: Entity enters into a long-term MSA with Customer A to provide an unspecified volume of non-customized parts. The price of the parts in subsequent years is dependent on Customer A's purchases in the current year. That is, Entity charges Customer A $1.00 per part in year one and if Customer A purchases more than 100,000 parts, its year two price will be $.90.

When making the determination whether the contract between Entity and Customer A includes a material right, Entity first evaluates whether the option provided to Customer A exists independently of the existing contract. To do this, Entity should compare the discount offered to Customer A with the discount typically offered to a similar high-volume customer that receives a discount independent of a prior contract with Entity. Such a similar customer could be Customer B who places a single order with Entity for 105,000 parts. Comparing the price offered to Customer A in year two with offers to other customers that also receive pricing that is contingent on prior purchases would not help Entity determine whether Customer A would have been offered the year two price had it not entered into the original contract.

The evaluation of when volume rebates results in material right will likely require significant judgment.

Question 4-16 **How should an entity account for the exercise of a material right? That is, should it be accounted for as a contract modification, a continuation of the existing contract or as variable consideration?** [30 March 2015 TRG meeting; agenda paper no. 32]

TRG members generally agreed that it would be reasonable for an entity to account for the exercise of a material right as either a contract modification or as a continuation of the existing contract (i.e., a change in the transaction price). TRG members also generally agreed it would not be appropriate to account for the exercise of a material right as variable consideration.

Although TRG members generally agreed that the standard could be interpreted to allow either approach, many TRG members favored treating the exercise of a material right as a continuation of the existing contract because the customer decided to purchase additional goods or services that were contemplated in the original contract (and not as part of a separate and subsequent negotiation). Under this approach, if a customer exercises a material right, an entity would update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise in accordance with the guidance on changes in the transaction price included in ASC 606-10-32-42 through 32-45 (see Section 6.5).

Under this guidance, changes in the total transaction price generally are allocated to the separate performance obligations on the same basis as the initial allocation. However, ASC 606-10-32-44 requires an entity to allocate a change in the transaction price entirely to one or more, but not all, performance obligations if the criteria of ASC 606-10-32-40 are met. These criteria (discussed further in Section 6.3) are that the additional consideration specifically relates to the entity's efforts to satisfy the performance obligation(s), and allocating the additional consideration entirely to one or more, but not all, performance obligation(s) is consistent with the standard's allocation objective (see Chapter 6). The additional consideration received for the exercise of the option would likely meet the criteria to be allocated directly to the performance obligation(s) underlying the material right and recognized when or as the performance obligation(s) is satisfied.

The TRG agenda paper included the following example:

Example of material right exercise under the guidance on changes in the transaction price

Entity enters into a contract with Customer to provide two years of Service A for $100 that also includes an option for Customer to purchase two years of Service B for $300. The standalone selling prices of Services A and B are $100 and $400, respectively. Entity concludes the option represents a material right and its estimate of the standalone selling price of the option is $33. Entity allocates the $100 transaction price to each performance obligation as follows:

	Transaction Price	Standalone selling price	%	Allocation
Service A		$ 100	75%	$ 75
Option		$ 33	25%	$ 25
Totals	$ 100	$ 133	100%	$ 100

Upon executing the contract, Customer pays $100 and Entity begins transferring Service A to Customer. The $75 allocated to Service A is recognized over the two-year service period. The $25 allocated to the option is deferred until Service B is transferred to the customer or the option expires. Six months after executing the contract, Customer exercises the option to purchase two years of Service B for $300. Under this approach, the $300 of consideration related to Service B is added to the amount previously allocated to the option to purchase Service B (i.e., $300 + 25 = $325) and is recognized as revenue over the two-year period in which Service B is transferred. Entity is able to allocate the additional consideration received for the exercise of the option as it specifically relates to Entity's efforts to satisfy the performance obligation and the allocation in this manner is consistent with the standard's allocation objective.

TRG members who favored the contract modification approach generally did so because the exercise of a material right also meets the definition of a contract modification in the standard (i.e., a change in the scope and/or price of a contract). Under this approach, an entity would follow the contract modification guidance in ASC 606-10-25-10 through 25-13 (see Section 3.4).

Because more than one approach would be acceptable, TRG members generally agreed that an entity will need to consider which approach is most appropriate based on the facts and circumstances and consistently apply that approach to similar contracts.

Question 4-17 **Is an entity required to evaluate whether a customer option that provides a material right includes a significant financing component? If so, are there any key factors an entity should consider when performing this evaluation?** [30 March 2015 TRG meeting; agenda paper no. 32]

TRG members generally agreed that an entity will have to evaluate whether a material right includes a significant financing component (see Section 5.5), as it would need to do for any other performance obligation. This will require judgment and consideration of the facts and circumstances.

However, as discussed in the TRG agenda paper on this question, a factor often present in customer options could be determinative in this evaluation. ASC 606-10-32-17(a) states that if a customer provides an advance payment for a good or service but the customer can choose when the good or service will be transferred, no significant financing component exists. As a result, if the customer can choose when to exercise the option, there likely is not a significant financing component.

4.7 Sale of products with a right of return

An entity may provide its customers with a right to return a transferred product. A right of return may be contractual, an implicit right that exists due to the entity's customary business practice or a combination of both (e.g., an entity has a stated return period but generally accepts returns over a longer period). A customer exercising its right to return a product may receive a full or partial refund, a credit applied to amounts owed, a different product in exchange or any combination of these items.

Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept a returned product. ASC 606-10-55-24 states that such an obligation does not represent a performance obligation. Instead, the Board concluded[104] that an entity makes an uncertain number of sales when it provides goods with a return right. That is, until the right of return expires, the entity is not certain how many sales will fail. Therefore, the Board concluded that an entity should not recognize revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods. Instead, the potential for customer returns should be considered when an entity estimates the transaction price because potential returns are a component of variable consideration. This concept is discussed further in Section 5.4.1.

ASC 606-10-55-28 states that exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one color or size for another) are not considered returns for the purposes of applying the standard. Generally, this would be a nonmonetary transaction within the scope of ASC 845. Further, contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties included in the standard (see Section 9.1).

[104] Paragraph BC364 of ASU 2014-09.

5 Determine the transaction price

The standard provides the following guidance on determining the transaction price:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

606-10-32-1

When (or as) a performance obligation **is satisfied, an entity shall recognize as** revenue **the amount of the** transaction price **(which excludes estimates of variable consideration that are constrained in accordance with paragraphs 606-10-32-11 through 32-13) that is allocated to that performance obligation.**

Determining the Transaction Price

606-10-32-2

An entity shall consider the terms of the contract **and its customary business practices to determine the** transaction price**. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a** customer**, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.**

606-10-32-2A

An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

606-10-32-3

The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

a. Variable consideration (see paragraphs 606-10-32-5 through 32-10 and 606-10-32-14)

b. Constraining estimates of variable consideration (see paragraphs 606-10-32-11 through 32-13)

c. The existence of a significant financing component in the contract (see paragraphs 606-10-32-15 through 32-20)

d. Noncash consideration (see paragraphs 606-10-32-21 through 32-24)

e. Consideration payable to a customer (see paragraphs 606-10-32-25 through 32-27).

> *606-10-32-4*
>
> For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

The transaction price is based on the amount to which the entity expects to be "entitled." This amount is meant to reflect the amount that the entity has rights to under the present contract (see Section 3.2 on contract enforceability and termination clauses). That is, the transaction price does not include estimates of consideration from future change orders for additional goods and services. The amount to which the entity expects to be entitled also excludes amounts collected on behalf of another party, such as sales taxes. As noted in the Basis for Conclusions of ASU 2014-09,[105] the Board decided that the transaction price should not include the effects of the customer's credit risk unless the contract includes a significant financing component (see Section 5.5).

Determining the transaction price is an important step in applying the standard because this amount is allocated to the identified performance obligations and is recognized as revenue as those performance obligations are satisfied. In many cases, the transaction price is readily determinable because the entity receives payment when it transfers promised goods or services, and the price is fixed (e.g., a restaurant's sale of food with a no refund policy). Determining the transaction price is more challenging when it is variable, when payment is received at a different time from when the entity provides the promised goods or services or when payment is in a form other than cash. Consideration paid or payable by the entity to the customer also may affect the determination of the transaction price.

5.1 Presentation of sales (and other similar) taxes

FASB amendments

In May 2016, the FASB issued ASU 2016-12 that allowed an entity to make an accounting policy election to exclude from the transaction price certain types of taxes collected from a customer (i.e., present revenue net of these taxes), including sales, use, value-added and some excise taxes.

The standard includes a general principle that an entity should determine the transaction price excluding amounts collected on behalf of third parties (e.g., some sales taxes). Constituents raised concerns that compliance with this aspect of the standard could be complex and costly for many entities because they would need to evaluate taxes they collect in each jurisdiction in which they operate to determine whether a tax is levied on the entity (and thus, the entity would include that amount in revenue and expenses) or the customer (and thus, the entity would exclude that amount from revenue and expenses because it is acting as a pass-through agent).

To alleviate these concerns, ASC 606-10-32-2A allows entities to make an accounting policy election to exclude sales taxes and other similar taxes from the measurement of the transaction price. An entity that makes this election should comply with the disclosure requirements of ASC 235-10-50-1 through 50-6. The FASB explained in the Basis for Conclusions of ASU 2016-12[106] that the scope of this accounting policy election is the same as the scope of the policy election in legacy GAAP, which the FASB determined is well established in practice. That is, the new guidance says the scope includes "all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes)" but not taxes imposed on an entity's gross receipts or the inventory procurement process.

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[105] Paragraph BC185 of ASU 2014-09.

[106] Paragraph BC33 of ASU 2016-12.

As the FASB noted in the Basis for Conclusions of ASU 2016-12,[107] if an entity elects to exclude sales taxes and other similar taxes from the measurement of the transaction price, the entity would make that election for all sales taxes and other similar taxes in the scope of the policy election. If an entity elects not to present all taxes within the scope of the policy election on a net basis, the entity would apply the guidance on determining the transaction price and would consider the principal versus agent guidance (see Section 4.4) to determine whether amounts collected from customers for those taxes should be included in the transaction price.

IASB differences

The IASB did not add a similar election to IFRS 15. As explained in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments), the IASB concluded the election was unnecessary because legacy IFRS contains similar requirements to those in IFRS 15 (and therefore the assessment of whether sales taxes are collected on behalf of a third party is not a new requirement for IFRS preparers).

5.2 Variable consideration

The transaction price reflects an entity's expectations about the consideration it will be entitled to receive from the customer. The standard provides the following guidance to determine whether consideration is variable and, if so, how it should be treated under the model:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Variable Consideration

606-10-32-5

If the consideration promised in a **contract** includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a **customer**.

606-10-32-6

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

606-10-32-7

The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.

[107] Paragraph BC32 of ASU 2016-12.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

These concepts are discussed in more detail below.

5.2.1 Forms of variable consideration

As indicated in ASC 606-10-32-6, "variable consideration" is defined broadly and can take many forms, including discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses and penalties. Variable consideration can result from explicit terms in a contract that the parties to the contract agreed on or can be implied by an entity's past business practices or intentions under the contract. It is important for entities to appropriately identify the different instances of variable consideration included in a contract because the second step of estimating variable consideration requires entities to apply a constraint (as discussed further in Section 5.2.3) to all variable consideration.

Many types of variable consideration identified in the standard are also considered variable consideration under legacy GAAP guidance. For example, if a portion of the transaction price depends on an entity meeting specified performance conditions and there is uncertainty about the outcome, this portion of the transaction price would be considered variable (or contingent) consideration under both legacy GAAP guidance and the new standard.

The FASB noted in the Basis for Conclusions of ASU 2014-09[108] that consideration can be variable even when the stated price in the contract is fixed. This is because the entity may be entitled to consideration only upon the occurrence or nonoccurrence of a future event. For example, the standard's definition of variable consideration includes amounts resulting from variability due to customer refunds or returns. As a result, a contract to provide a customer with 100 widgets at a fixed price per widget would be considered to include a variable component if the customer has the ability to return the widgets (see Section 5.4.1).

In many transactions, entities have variable consideration as a result of rebates and/or discounts on the price of products or services they provide to customers once the customers meet specific volume thresholds. The standard contains the following example relating to volume discounts:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 24 — Volume Discount Incentive

606-10-55-216

An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for $100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to $90 per unit. Consequently, the consideration in the contract is variable.

606-10-55-217

For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

[108] Paragraph BC191 of ASU 2014-09.

606-10-55-218

The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

606-10-55-219

In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to $90.

606-10-55-220

Consequently, the entity recognizes revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

Question 5-1 **Should volume rebates and/or discounts on goods or services be accounted for as variable consideration or as customer options to acquire additional goods or services at a discount?**

See response to Question 4-14 in Section 4.6.

Question 5-2 **How should an entity distinguish between a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration based on a variable quantity (e.g., a usage-based fee)?** [9 November 2015 TRG meeting; agenda paper no. 48]

See response to Question 4-12 in Section 4.6.

Question 5-3 **Should liquidated damages, penalties or compensation from other similar clauses be accounted for as variable consideration or warranty provisions under the standard?**

Most liquidated damages, penalties and similar payments should be accounted for as variable consideration. However, in limited situations, we believe that amounts that are based on the actual performance of a delivered good or service may be considered similar to warranty payments (e.g., in situations in which an entity pays the customer's direct costs to remedy a defect).

Some contracts provide for liquidated damages, penalties or other damages if an entity fails to deliver future goods or services or if the goods or services fail to meet certain specifications. ASC 606-10-32-6 includes "penalties" as an example of variable consideration and describes how promised consideration in a contract can be variable if the right to receive the consideration is contingent on the occurrence or nonoccurrence of a future event (e.g., the contract specifies that a vendor pays a penalty if it fails to perform according to the agreed-upon terms).

Penalties and other clauses that are considered similar to warranty provisions would be accounted for as (1) consideration paid or payable to a customer (which may be treated as variable consideration, see Section 5.7) or (2) an assurance- or service-type warranty (see Section 9.1 on warranties). Cash fines or penalties paid to a customer generally should be accounted for under the guidance on consideration payable to a customer. However, we believe there may be situations in which it is appropriate to account for cash payments as an assurance- type warranty (e.g., an entity's direct reimbursement to the customer for costs paid by the customer to a third party for repair of a product).

Question 5-4 **If a contract includes an undefined quantity of outputs but the contractual rate per unit is fixed, is the consideration variable?** [13 July 2015 TRG meeting; agenda paper no. 39]

Yes. TRG members generally agreed that if a contract includes an unknown quantity of tasks throughout the contract period for which the entity has enforceable rights and obligations (i.e., the unknown quantity of tasks is not an option to purchase additional goods and services, as described in Question 4-12 in Section 4.6) and the consideration received is contingent upon the quantity completed, the total transaction price would be variable. That's because the contract has a range of possible transaction prices, and the ultimate consideration will depend on the occurrence or nonoccurrence of a future event (e.g., customer usage), even though the rate per unit is fixed.

The TRG agenda paper noted that an entity would need to consider contractual minimums (or other clauses) that would make some or all of the consideration fixed.

Question 5-5 **If a contract is denominated in a currency other than that of the entity's functional currency, should changes in the contract price due to exchange rate fluctuations be accounted for as variable consideration?**

We believe that changes to the contract price due to exchange rate fluctuations do not result in variable consideration. These price fluctuations are a consequence of entering into a contract that is denominated in a foreign currency rather than a result of a contract term like a discount or rebate or one that depends on the occurrence or nonoccurrence of a future event, as described in ASC 606-10-32-6.

This answer is consistent with the guidance on noncash consideration in ASC 606-10-32-23 that says that variability due to the form of noncash consideration should not be considered variable consideration. The variability resulting from changes in foreign exchange rates relates to the form of the consideration (i.e., it is in a currency other than the entity's functional currency) so, under the noncash consideration principles, it would not be considered variable consideration when determining the transaction price. This variability would be accounted for under ASC 830-20 on foreign currency transactions.

5.2.1.1 Implicit price concessions

For some contracts, the stated price has easily identifiable variable components. However, for other contracts, the consideration may be variable because the facts and circumstances indicate that the entity may accept a lower price than the amount stated in the contract (i.e., it expects to provide an implicit price concession). This could be a result of the customer having a reasonable expectation that the entity will reduce its price based on the entity's customary business practices, published policies or statements made by the entity.

An implicit price concession also could result from other facts and circumstances indicating that the entity intended to offer a price concession to the customer when it entered into the contract. For example, an entity may accept a lower price than the amount stated in the contract to develop or enhance a customer relationship or because the incremental cost of providing the service to the customer is not significant and the consideration it expects to collect provides a sufficient margin.

The standard provides the following example of when an implicit price concession exists and the transaction price therefore is not the amount stated in the contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 2 — Consideration Is Not the Stated Price — Implicit Price Concession

606-10-55-99

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of $1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

606-10-55-100

When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraphs 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not $1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to $400,000.

606-10-55-101

The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect $400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of $400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the guidance in this Topic.

Variable consideration also may result from extended payment terms in a contract and any resulting uncertainty about whether the entity will be willing to accept a lower payment amount in the future. That is, an entity will have to evaluate whether the extended payment terms represent an implied price concession because the entity does not intend to, or will not be able to, collect all amounts due in future periods. However, the standard does not require entities to presume that extended payment terms lead to a transaction price that is not fixed or determinable, as they are required to do under legacy software revenue guidance. As a result, the new guidance could be less onerous for entities that apply ASC 985-605 under legacy GAAP and may accelerate the recognition of revenue for some of them.

In the Basis for Conclusions of ASU 2014-09,[109] the FASB acknowledged that in some cases, it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (i.e., impairment losses). The Board did not develop detailed guidance for distinguishing between price concessions (recognized as variable consideration through revenue) and impairment losses (recognized

[109] Paragraph BC194 of ASU 2014-09.

as bad debt expense outside of revenue). Therefore, entities should consider all relevant facts and circumstances when analyzing situations in which an entity is willing to accept a lower price than the amount stated in the contract.

Appropriately distinguishing between price concessions (i.e., reductions of revenue) and customer credit risk (i.e., bad debt) for collectibility concerns that were known at contract inception is important because it will affect whether a valid contract exists (see Section 3.1) and the subsequent accounting for the transaction. If an entity determines at contract inception that a contract includes a price concession (i.e., variable consideration), any change in the estimate of the amount the entity expects to collect, absent an identifiable credit event, will be accounted for as a change in the transaction price. That is, a decrease in the amount the entity expects to collect should be recorded as a reduction in revenue and not a bad debt expense, unless there is an event that affects a customer's ability to pay some or all of the transaction price (e.g., a known decline in a customer's operations, a bankruptcy filing). As illustrated in Example 2 above, entities may estimate a transaction price that is significantly lower than the stated invoice or contractual amount but still consider the difference between those amounts to be variable consideration (e.g., a price concession) rather than a collectibility issue related to bad debt.

5.2.2 Estimating variable consideration

An entity is required to estimate variable consideration using either an "expected value" or the "most likely amount" method, as described in the standard:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Variable Consideration

606-10-32-8

An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value — The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount — The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

606-10-32-9

An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

An entity should chose the expected value method or the most likely amount method based on which method better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a "free choice." Rather, an entity selects the method based on the specific facts and circumstances of the contract.

The entity should apply the selected method consistently to each type of variable consideration throughout the contract term and update the estimated variable consideration at each reporting date. The entity also should apply that method consistently for similar types of variable consideration in similar contracts. In the Basis for Conclusions of ASU 2014-09,[110] the FASB noted that a contract may contain different types of variable consideration and that it may be appropriate for an entity to use different methods (i.e., expected value or most likely amount) for estimating different types of variable consideration within a single contract.

Entities will determine the expected value of variable consideration using the sum of probability-weighted amounts in a range of possible amounts under the contract. To do this, an entity will need to identify the possible outcomes of a contract and the probabilities of those outcomes. The FASB indicated in the Basis for Conclusions of ASU 2014-09[111] that the expected value method may better predict expected consideration when an entity has a large number of contracts with similar characteristics. This method also may better predict consideration when an entity has a single contract with a large number of possible outcomes. The FASB clarified in the Basis for Conclusions of ASU 2014-09[112] that an entity preparing an expected value calculation is not required to consider all possible outcomes, even if it has extensive data and can identify many possible outcomes. Instead, the FASB indicated that, in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value.

Entities will determine the most likely amount of variable consideration using the single most likely amount in a range of possible consideration amounts. The FASB indicated in the Basis for Conclusions of ASU 2014-09[113] that the most likely amount method may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus, but not a portion of that bonus).

The standard states that when applying either of these methods, an entity should consider all information (historical, current and forecast) that is reasonably available to the entity. Some constituents questioned whether an entity would be applying the portfolio approach practical expedient in ASC 606-10-10-4 (see Section 3.3.1) when considering evidence from other, similar contracts to develop an estimate of variable consideration using an expected value method. TRG members discussed[114] this question and generally agreed that an entity would not be applying the portfolio approach practical expedient if it used a portfolio of data from its historical experience with similar customers and/or contracts. TRG members noted that an entity could choose to apply the portfolio approach practical expedient but would not be required to do so. Use of this practical expedient requires an entity to assert that it does not expect the use of the expedient to differ materially from applying the guidance to an individual contract. The TRG agenda paper noted that using a portfolio of data is not equivalent to using the portfolio approach practical expedient, so entities that use the expected value method to estimate variable consideration would not be required to assert that the outcome from the portfolio is not expected to materially differ from an assessment of individual contracts.

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[110] Paragraph BC202 of ASU 2014-09.

[111] Paragraph BC200 of ASU 2014-09.

[112] Paragraph BC201 of ASU 2014-09.

[113] Paragraph BC200 of ASU 2014-09.

[114] 13 July 2015 TRG meeting; agenda paper no. 38.

How we see it

Many entities will see significant changes in how they account for variable consideration. This will be an even more significant change for entities that do not attempt to estimate variable consideration under legacy GAAP and simply recognize such amounts when cash is received or known with a high degree of certainty (e.g., upon receipt of a report from a customer detailing the amount of revenue due to the entity).

For example, the standard will change practice for many entities that sell their products through distributors or resellers. Because the sales price to the distributor or reseller may not be finalized until the product is sold to the end customer, many of these entities wait until the product is sold to the end customer to recognize revenue under legacy GAAP. The basis for this practice, known as the "sell-through" method, is that the sales price is not considered "fixed or determinable," one of the general revenue recognition requirements of SAB Topic 13, until the product is sold to the end customer.

Under the standard, the practice of waiting until the product is sold to the end customer to recognize any revenue may no longer be acceptable if the only uncertainty is the variability in the pricing. This is because the standard requires an entity to estimate the variable consideration (i.e., the end sales price) based on the information available, taking into consideration the effect of the constraint on variable consideration. However, in some cases, the outcomes under the standard and legacy methods could be similar if a significant portion of the estimated revenue is constrained.

5.2.3 Constraining estimates of variable consideration

Before it can include any amount of variable consideration in the transaction price, an entity must consider whether the amount of variable consideration is constrained. The Board explained in the Basis for Conclusions of ASU 2014-09[115] that it created this constraint on variable consideration to address concerns raised by many constituents that the standard otherwise could require recognition of revenue before there is sufficient certainty that the amounts recognized would faithfully depict the consideration to which an entity expects to be entitled in exchange for the goods or services transferred to a customer.

The FASB said in the Basis for Conclusions of ASU 2014-09[116] that it did not intend to eliminate the use of estimates from the revenue recognition guidance. Instead, it wanted to make sure estimates are robust and result in useful information. Following this objective, the FASB concluded it was appropriate to include estimates of variable consideration in revenue only when an entity has "a high degree of confidence" that revenue will not be reversed in a subsequent reporting period. Therefore, as the following excerpt from the standard states, the constraint is aimed at preventing the over-recognition of revenue (i.e., the language focuses on potential significant reversals of revenue):

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Constraining Estimates of Variable Consideration

606-10-32-11

An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is **probable** that a significant reversal in the amount of cumulative **revenue** recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

[115] Paragraph BC203 of ASU 2014-09.

[116] Paragraph BC204 of ASU 2014-09.

606-10-32-12

In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

606-10-32-13

An entity shall apply paragraph 606-10-55-65 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of intellectual property.

To include variable consideration in the estimated transaction price, the entity has to conclude that it is "probable" that a significant revenue reversal will not occur in future periods. For purposes of this analysis, the meaning of the term "probable" is consistent with the existing definition in US GAAP and is defined as "the future event or events are likely to occur." Further, the FASB noted[117] that an entity's analysis to determine whether its estimate of variable consideration should (or should not) be constrained largely will be qualitative. That is, an entity will need to use judgment to evaluate whether it has met the objective of the constraint (i.e., it is probable that a significant revenue reversal will not occur in future periods) considering the factors provided in the standard that increase the probability of a significant revenue reversal.

An entity will need to consider both the likelihood and magnitude of a revenue reversal to apply the constraint.

- **Likelihood** — Assessing the likelihood of a future reversal of revenue will require significant judgment, and entities will want to make sure they adequately document the basis for their conclusions. The presence of any one of the indicators cited in the excerpt above does not necessarily mean that a reversal will occur if the variable consideration is included in the transaction price. The standard includes "factors" rather than "criteria" to signal that the list of items to consider is not a checklist for which all items have to be met. In addition, the indicators provided are not meant to be an all-inclusive list, and entities may consider additional factors that are relevant to their facts and circumstances.

[117] Paragraph BC212 of ASU 2014-09.

- **Magnitude** — When assessing the probability of a significant revenue reversal, an entity also is required to assess the magnitude of that reversal. The constraint is based on the probability of a reversal of an amount that is "significant" relative to cumulative revenue recognized for the contract. When assessing the significance of the potential revenue reversal, the cumulative revenue recognized at the date of the potential reversal should include both fixed and variable consideration and should include revenue recognized from the entire contract, not only the transaction price allocated to a single performance obligation.

Some types of variable consideration that are frequently included in contracts have significant uncertainties. It will likely be more difficult for an entity to assert that it is probable that these types of estimated amounts will not be subsequently reversed. Such types of variable consideration include the following:

- Payments contingent on regulatory approval (e.g., Food and Drug Administration approval of a new drug)
- Long-term commodity supply arrangements that settle based on market prices at the future delivery date
- Contingency fees based on litigation or regulatory outcomes (e.g., fees based on the positive outcome of litigation or on the settlement of claims with governmental agencies)

When an entity determines that it cannot meet the probable threshold if it includes all of the variable consideration in the transaction price, the amount of variable consideration that must be included in the transaction price is limited to the amount that *will not* result in a significant revenue reversal. That is, an entity is required to include in the transaction price the portion of variable consideration that will not result in a significant revenue reversal when the uncertainty associated with the variable consideration is subsequently resolved.

The standard includes an example in which the application of the constraint limits the amount of variable consideration included in the transaction price and one in which it does not:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 23 — Price Concessions

606-10-55-208

An entity enters into a contract with a customer, a distributor, on December 1, 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of $100 per product (total consideration is $100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on December 1, 20X7.

606-10-55-209

On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A — Estimate of Variable Consideration Is Not Constrained

606-10-55-210

The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 percent of the sales price for these products. Current market information suggests that a 20 percent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 percent in many years.

606-10-55-211

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be $80,000 ($80 × 1,000 products).

606-10-55-212

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $80,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $80,000) will not occur when the uncertainty is resolved (that is, when the total amount of price concessions is determined). Consequently, the entity recognizes $80,000 as revenue when the products are transferred on December 1, 20X7.

Case B — Estimate of Variable Consideration Is Constrained

606-10-55-213

The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence, and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20 to 60 percent of the sales price for similar products. Current market information also suggests that a 15 to 50 percent reduction in price may be necessary to move the products through the distribution chain.

606-10-55-214

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 percent will be provided and, therefore, the estimate of the variable consideration is $60,000 ($60 × 1,000 products).

606-10-55-215

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of $60,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (that is, risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of $60,000 (that is, a discount of 40 percent) in the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Although the entity's historical price concessions have ranged from 20 to 60 percent, market information currently suggests that a price concession of 15 to 50 percent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $50,000 in the transaction price ($100 sales price and a 50 percent price concession) and, therefore, recognizes revenue at that amount. Therefore, the entity recognizes revenue of $50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 606-10-32-14.

In some situations, it will be appropriate for an entity to include in the transaction price an estimate of variable consideration that is not a possible outcome of an individual contract. The TRG discussed this topic[118] using the following example from the TRG agenda paper:

Example of estimating variable consideration using the expected value method

Entity A develops websites for customers. The contracts include similar terms and conditions and contain a fixed fee plus variable consideration for a performance bonus related to the timing of Entity A completing the website. Based on Entity A's historical experience, the bonus amounts and associated probabilities for achieving each bonus are as follows:

Bonus amount	Probability of outcome
$ –	15%
$ 50,000	40%
$ 100,000	45%

Entity A determines that using the expected value method would better predict the amount of consideration to which it will be entitled than using the most likely amount method because it has a large number of contracts that have characteristics that are similar to the new contract.

Under the expected value method, Entity A estimates variable consideration of $65,000 ((0 x 15%) + (50,000 x 40%) + (100,000 x 45%)). Entity A must then consider the effect of applying the constraint on variable consideration. To do this, Entity A considered the factors that could increase the likelihood of a revenue reversal in ASC 606-10-32-12 and concluded that it has relevant historical experience with similar types of contracts and that the amount of consideration is not highly susceptible to factors outside of its influence.

In determining whether the entity would include $50,000 or $65,000 in the transaction price, TRG members generally agreed that when an entity has concluded that the expected value approach is the appropriate method to estimate variable consideration, the constraint is also applied based on the expected value method. That is, the entity is not required to switch from an expected value method to a most likely amount for purposes of applying the constraint. As a result, if an entity applies the expected value method for a particular contract, the estimated transaction price might not be a possible outcome in an individual contract. Therefore, the entity could conclude that, in this example, $65,000 is the appropriate estimate of variable consideration to include in the transaction price. It is important to note that in this example, the entity had concluded that none of the factors in ASC 606-10-32-12 or any other factors indicate a likelihood of a significant revenue reversal.

When an entity uses the expected value method and determines that the estimated amount of variable consideration is not a possible outcome in the individual contract, the entity must still consider the constraint on variable consideration. Depending on the facts and circumstances of each contract, an entity may need to constrain its estimate of variable consideration, even though it used an expected value method, if the factors in ASC 606-10-32-12 indicate a likelihood of a significant revenue reversal. However, using the expected value method and considering probability-weighted amounts sometimes achieves the objective of the constraint on variable consideration. When an entity estimates the transaction price using the expected value method, the entity reduces the probability of a revenue reversal because the estimate does not include all of the potential consideration due to the probability weighting of outcomes and in some cases, the entity may not need to constrain the estimate of variable consideration if the factors in ASC 606-10-32-12 do not indicate a likelihood of a significant revenue reversal.

[118] 13 July 2015 TRG meeting; agenda paper no. 38.

The standard provides the following example of a situation in which a qualitative analysis of the factors in ASC 606-10-32-12 indicates that it is not probable that a significant reversal would not occur if an entity includes a performance-based incentive fee in the transaction price of an investment management contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 25 — Management Fees Subject to the Constraint

606-10-55-221

On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

606-10-55-222

The entity accounts for the services as a single performance obligation in accordance with paragraph 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

606-10-55-223

At contract inception, the entity considers the guidance in paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity observes that the promised consideration is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

606-10-55-224

At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception — the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. At March 31, 20X8, the client's assets under management are $100 million. Therefore, the resulting quarterly management fee and the transaction price is $2 million.

606-10-55-225

At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 606-10-32-28. Consequently, the entity recognizes $2 million as revenue for the quarter ended March 31, 20X8.

See Chapter 6 for a discussion of allocating the transaction price.

How we see it

We anticipate that questions will arise involving the application of the constraint on variable consideration to specific fact patterns, including the determination of when it is probable that a significant revenue reversal would not occur. The constraint is a new way of evaluating variable consideration, and it applies to all types of variable consideration in all transactions. (However, there are specific requirements for sales- or usage-based royalties associated with a license of intellectual property that constrain the recognition of those royalties, which may result in a similar outcome to fully constraining the estimate of those royalties.)

Legacy GAAP has various requirements and thresholds for recognizing variable consideration. As a result, the accounting treatment varies depending on which guidance applies to a transaction. For example, the revenue recognition guidance in ASC 605-25 limits the recognition of contingent consideration when the amounts depend on the future performance of the entity, and SAB Topic 13 requires that the transaction price be fixed or determinable in order to recognize revenue. Other guidance is less restrictive and allows entities to estimate and recognize at least portions of the variable consideration in an arrangement. For example, under ASC 605-20,[119] entities have the option of recognizing performance-based incentive fees on an "as if earned" basis, based on the amount due as if the contract had been terminated and the fees realized at that date (i.e., Method 2). As a result, depending on which guidance entities have been applying, some entities may recognize revenue sooner under the new standard, while others may recognize revenue later.

IASB differences

The IASB uses the term "highly probable" in its standard as the confidence threshold for applying the constraint. While a different term is used, it is intended to have the same meaning as probable under US GAAP.

Question 5-6 **Should the constraint on variable consideration be applied at the contract or performance obligation level?** [26 January 2015 TRG meeting; agenda paper no. 14]

TRG members generally agreed that the constraint should be applied at the contract level and not at the performance obligation level. That is, the significance assessment of the potential revenue reversal should contemplate the total transaction price of the contract (and not the transaction price allocated to the performance obligation).

Constituents raised this question because the standard refers to "cumulative revenue recognized" without specifying the level at which this assessment should be performed (i.e., at the contract or performance obligation). Further, the Basis for Conclusions of ASU 2014-09[120] could be read to indicate that the assessment should occur in relation to the cumulative revenue recognized for a performance obligation.

[119] ASC 605-20-S99-1 (formerly EITF D-96).

[120] Paragraph BC217 of ASU 2014-09.

Question 5-7 **Does the variable consideration guidance (including the application of the constraint) apply to all types of variable consideration?**

The measurement principles of variable consideration should be applied to all types of variable consideration. However, there are specific requirements for sales- or usage-based royalties associated with a license of intellectual property that constrain the recognition of those royalties, which may result in a similar outcome to fully constraining the estimate of those royalties. Such royalties should not be recognized as revenue until the later of the following: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated has been satisfied (or partially satisfied), as discussed further in Section 8.5.

Question 5-8 **Must an entity follow a two-step approach to estimate variable consideration (i.e., first estimate the variable consideration and then apply the constraint to that estimate)?**

No. The FASB noted in the Basis for Conclusions of ASU 2014-09[121] that an entity is not required to strictly follow a two-step process (i.e., first estimate the variable consideration and then apply the constraint to that estimate) if its internal processes incorporate the principles of both steps in a single step. For example, if an entity already has a single process to estimate expected returns when calculating revenue from the sale of goods in a manner consistent with the objectives of applying the constraint, the entity would not need to estimate the transaction price and then separately apply the constraint.

A TRG agenda paper[122] also noted that applying the expected value method, which requires an entity to consider probability-weighted amounts, sometimes can achieve the objective of the constraint on variable consideration. That is, in developing its estimate of the transaction price in accordance with the expected value method, an entity reduces the probability of a revenue reversal and might not need to further constrain its estimate of variable consideration. However, to meet the objective of the constraint, the entity's estimated transaction price would need to incorporate its expectations of the possible consideration amounts (e.g., products not expected to be returned) at a level at which it is probable that including the estimate of variable consideration in the transaction price would not result in a significant revenue reversal (e.g., it is probable that additional returns above the estimated amount would not result in a significant reversal).

5.2.4 Reassessment of variable consideration

The standard includes the following guidance on reassessing variable consideration:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Reassessment of Variable Consideration

606-10-32-14

At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 606-10-32-42 through 32-45.

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[121] Paragraph BC215 of ASU 2014-09.

[122] 13 July 2015 TRG meeting; agenda paper no. 38.

When a contract includes variable consideration, an entity will need to update its estimate of the transaction price throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating the estimate of the variable consideration (including any amounts that are constrained) to reflect an entity's revised expectations about the amount of consideration to which it expects to be entitled considering uncertainties that are resolved or new information that is gained about remaining uncertainties. See Section 6.5 for a discussion of allocating changes in the transaction price after contract inception.

5.3 Refund liabilities

An entity may receive consideration that it will need to refund to the customer in the future because the consideration is not an amount to which the entity ultimately will be entitled under the contract. These amounts received (or receivable) will need to be recorded as refund liabilities. The standard includes the following guidance on refund liabilities:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Refund Liabilities

606-10-32-10

An entity shall recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, amounts not included in the **transaction price**). The refund liability (and corresponding change in the transaction price and, therefore, the **contract liability**) shall be updated at the end of each reporting period for changes in circumstances. To account for a refund liability relating to a sale with a right of return, an entity shall apply the guidance in paragraphs 606-10-55-22 through 55-29.

While the most common form of refund liabilities may be related to sales with a right of return, the refund liability guidance also will apply when an entity expects that it will need to refund consideration received due to poor customer satisfaction with a service provided (i.e., there was no good delivered or returned) and/or if an entity expects to have to provide retrospective price reductions to a customer (e.g., if a customer reaches a certain threshold of purchases, the unit price will be retroactively adjusted). For a discussion of the accounting for sales with a right of return, see Section 5.4.1.

Question 5-9 **Is a refund liability a contract liability (and thus subject to the presentation and disclosure requirements of a contract liability)?**

See response to Question 10-4 in Section 10.1.

5.4 Accounting for specific types of variable consideration

5.4.1 Rights of return

As discussed in Section 4.7, the standard says that a right of return does not represent a separate performance obligation. Instead, a right of return affects the transaction price and the amount of revenue an entity can recognize for satisfied performance obligations. In other words, rights of return create variability in the transaction price.

The standard provides the following guidance to determine how rights of return should be treated under the model:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Sale with a Right of Return

606-10-55-22

In some **contracts**, an entity transfers control of a product to a **customer** and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

a. A full or partial refund of any consideration paid

b. A credit that can be applied against amounts owed, or that will be owed, to the entity

c. Another product in exchange.

606-10-55-23

To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following:

a. **Revenue** for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)

b. A refund liability

c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

606-10-55-24

An entity's promise to stand ready to accept a returned product during the return period should not be accounted for as a **performance obligation** in addition to the obligation to provide a refund.

606-10-55-25

An entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the **transaction price** and, therefore, in the amount of revenue recognized.

606-10-55-26

An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

606-10-55-27

An asset recognized for an entity's right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity should update the measurement of the asset arising from changes in expectations about products to be returned. An entity should present the asset separately from the refund liability.

606-10-55-28

Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one color or size for another) are not considered returns for the purposes of applying the guidance in this Topic.

606-10-55-29

Contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties in paragraphs 606-10-55-30 through 55-35.

Under the standard, an entity will estimate the transaction price and apply the constraint to the estimated transaction price. In doing so, it will consider the products expected to be returned to determine the amount to which the entity expects to be entitled (excluding consideration for the products expected to be returned). The entity will recognize revenue based on the amount to which it expects to be entitled through the end of the return period (considering expected product returns). An entity will not recognize the portion of the revenue subject to the constraint until the amount is no longer constrained, which could be at the end of the return period. The entity will recognize the amount received or receivable that is expected to be returned as a refund liability, representing its obligation to return the customer's consideration (see Section 5.3).

As part of updating its estimate of amounts to which it expects to be entitled in a contract, an entity must update its assessment of expected returns and the related refund liabilities. This remeasurement is performed at each financial reporting date and reflects any changes in assumptions about expected returns. Any adjustments made to the estimate will result in a corresponding adjustment to amounts recognized as revenue for the satisfied performance obligations (e.g., if the entity expects the number of returns to be lower than originally estimated, it would have to increase the amount of revenue recognized and decrease the refund liability).

Finally, when customers exercise their rights of return, the entity may receive the returned product in salable or reparable condition. Under the standard, at the time of the initial sale (when recognition of revenue is deferred due to the anticipated return), the entity recognizes a return asset (and adjusts cost of sales) for its right to recover the goods returned by the customer. The entity initially measures this asset at the former carrying amount of the inventory, less any expected costs to recover the goods including potential decreases in value of the returned goods. Along with remeasuring the refund liability at each reporting date, the entity updates the measurement of the asset recorded for any revisions to its expected level of returns, as well as any additional decreases in the value of the returned products.

The standard requires the carrying value of the return asset to be presented separately from inventory and subject to impairment testing on its own, separately from inventory on hand. The standard also requires the refund liability to be presented separately from the corresponding asset (on a gross basis rather than a net basis).

The standard provides the following example of rights of return:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 22 — Right of Return

606-10-55-202

An entity enters into 100 contracts with customers. Each contract includes the sale of 1 product for \$100 (100 total products × \$100 = \$10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is \$60.

606-10-55-203

The entity applies the guidance in this Topic to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 606-10-10-4, the effects on the financial statements from applying this guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within the portfolio.

606-10-55-204

Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

606-10-55-205

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of \$9,700 (\$100 × 97 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (that is, the 30-day return period). Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$9,700) will not occur as the uncertainty is resolved (that is, over the return period).

606-10-55-206

The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

606-10-55-207

Upon transfer of control of the 100 products, the entity does not recognize revenue for the 3 products that it expects to be returned. Consequently, in accordance with paragraphs 606-10-32-10 and 606-10-55-23, the entity recognizes the following:

Cash	\$ 10,000		(\$100 × 100 products transferred)
Revenue		\$ 9,700	(\$100 × 97 products not expected to be returned)
Refund liability		\$ 300	(\$100 refund × 3 products expected to be returned)
Cost of sales	\$ 5,820		(\$60 × 97 products not expected to be returned)
Asset	\$ 180		(\$60 × 3 products for its right to recover products from customers on settling the refund liability)
Inventory		\$ 6,000	(\$60 × 100 products)

How we see it

While the standard's accounting treatment for rights of return may not significantly change practice under legacy GAAP, there are some notable differences. The changes in this area (primarily treating the right of return as a type of variable consideration that must be accounted for using the variable consideration guidance, including the application of the constraint) may affect manufacturers and retailers that otherwise may not be significantly affected by the new guidance. Entities will have to assess whether their models for estimating returns are appropriate, given the need to consider the constraint.

Separately presenting the right of return asset and refund liability on the balance sheet will be a change in practice from legacy GAAP for many entities. Under legacy GAAP, the carrying value associated with any product expected to be returned typically remains in inventory and is not subject to separate impairment testing (although when the value of returned product is expected to be zero, inventory is fully expensed at the time of sale).

Question 5-10 **Is an entity applying the portfolio approach practical expedient when accounting for rights of return?** [13 July 2015 TRG meeting; agenda paper no. 38]

An entity can, but would not be required to, apply the portfolio approach practical expedient to estimate variable consideration for expected returns using the expected value method. Similar to the discussion in Section 5.2.2 on estimating variable consideration, the TRG agenda paper noted that an entity can consider evidence from other, similar contracts to develop an estimate of variable consideration using the expected value method without applying the portfolio approach practical expedient. In order to estimate variable consideration in a contract, an entity frequently will make judgments considering its historical experience with other, similar contracts. Considering historical experience does not necessarily mean the entity is applying the portfolio approach practical expedient.

This question arises, in part, because Example 22 from the standard (above) states that the entity is using the portfolio approach practical expedient in ASC 606-10-10-4 to calculate its estimate of returns. Use of this practical expedient requires an entity to assert that it does not expect the use of the expedient to differ materially from applying the guidance to an individual contract.

We expect that entities often will use the expected value method to estimate variable consideration related to returns because doing so would likely better predict the amount of consideration to which the entities will be entitled. This is in spite of the fact that there are two potential outcomes for each contract from the variability of product returns: the product either will be returned or will not be returned. That is, the revenue for each contract ultimately either will be 100% or will be 0% of the total contract value (assuming returns create the only variability in the contract). However, entities may conclude that the expected value is the appropriate method for estimating variable consideration because they have a large number of contracts with similar characteristics. The TRG agenda paper noted that using a portfolio of data is not equivalent to using the portfolio approach practical expedient, so entities that use the expected value method to estimate variable consideration for returns would not be required to assert that the outcome from the portfolio is not expected to materially differ from an assessment of individual contracts.

Question 5-11 **How should an entity account for restocking fees for goods that are expected to be returned?** [13 July 2015 TRG meeting; agenda paper no. 35]

TRG members generally agreed that restocking fees for goods expected to be returned should be included in the estimate of the transaction price at contract inception and recorded as revenue when (or as) control of the good transfers.

For example, assume that an entity enters into a contract with a customer to sell 10 widgets for $100 each. The customer has the right to return the widgets, but if it does so, it will be charged a 10% restocking fee (or $10 per returned widget). The entity estimates that 10% of all widgets sold will be returned. Upon transfer of control of the 10 widgets, the entity will recognize revenue of $910 ((9 widgets not expected to be returned x $100 selling price) + (1 widget expected to be returned x $10 restocking fee)). A refund liability of $90 also will be recorded (1 widget expected to be returned x ($100 selling price — $10 restocking free)).

Question 5-12 **How should an entity account for restocking costs related to expected returns (e.g., shipping or repackaging costs)?** [13 July 2015 TRG meeting; agenda paper no. 35]

TRG members generally agreed that restocking costs should be recorded as a reduction of the amount of the return asset when (or as) control of the good transfers. This accounting will be consistent with the standard's requirement that the return asset be initially measured at the former carrying amount of the inventory, less any expected costs to recover the goods (e.g., restocking costs).

Question 5-13 **When an entity has a conditional call option to remove and replace expired products (e.g., out-of-date perishable goods, expired medicine), does the customer obtain control of the products (or is it akin to a right of return)?**

See response to Question 7-10 in Section 7.3.2.

5.4.2 Sales- and usage-based royalties on licenses of intellectual property

The standard provides explicit guidance for recognizing consideration from sales- and usage-based royalties provided in exchange for licenses of intellectual property. The standard states that an entity should recognize sales- and usage-based royalties as revenue only when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). In many cases, the application of this guidance will result in the same pattern of revenue recognition as fully constraining the estimate of variable consideration associated with the future royalty stream. See Section 8.5 for further discussion about the sales- and usage-based royalties on licenses of intellectual property.

5.5 Significant financing component

For some transactions, the receipt of consideration does not match the timing of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

The standard states the following in relation to a significant financing component in a contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

The Existence of a Significant Financing Component in the Contract

606-10-32-15

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the **contract** (either explicitly or implicitly) provides the **customer** or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

606-10-32-16

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize **revenue** at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services

b. The combined effect of both of the following:

   1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services

   2. The prevailing interest rates in the relevant market.

606-10-32-17

Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.

b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

606-10-32-18

As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

606-10-32-19

To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

The Board explained in the Basis for Conclusions of ASU 2014-09[123] that, conceptually, a contract that includes a financing component includes two transactions — one for the sale of goods and/or services and one for the financing. Accordingly, the Board decided to require entities to adjust the amount of promised consideration for the effects of financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing. The FASB's objective[124] in requiring entities to adjust the promised amount of consideration for the effects of a significant financing component was for entities to recognize as revenue the "cash selling price" of the underlying goods or services at the time of transfer.

However, an entity is not required to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. The Board added[125] this practical expedient to the standard because it simplifies the application of this aspect of ASC 606 and because the effect of accounting for a significant financing component (or of not doing so) should be limited in financing arrangements with a duration of less than 12 months. If an entity uses this practical expedient, it should apply the expedient consistently to similar contracts in similar circumstances.[126]

Entities may need to apply judgment to determine whether the practical expedient applies to some contracts. For example, the standard does not specify whether entities should assess the period between payment and performance at the contract level or at the performance obligation level. In addition, the TRG discussed how an entity should consider whether the practical expedient applies to contracts with a single payment stream for multiple performance obligations. See Question 5-19 below.

Absent the use of the practical expedient, to determine whether a significant financing component exists, an entity will need to consider all relevant facts and circumstances, including: (1) the difference between the cash selling price and the amount of promised consideration for the promised goods or services and (2) the combined effect of the expected length of time between the transfer of the goods or services and the receipt of consideration and the prevailing market interest rates. The Board acknowledged[127] that a difference in the timing between the transfer of and payment for goods and services is not determinative, but the combined effect of timing and the prevailing interest rates may provide a strong indication that an entity is providing (or receiving) a significant benefit of financing.

Even if conditions in a contract otherwise would indicate that a significant financing component exists, the standard includes several situations that the Board determined do not provide the customer or the entity with a significant benefit of financing. These situations, as described in ASC 606-10-32-17, include the following:

- The customer has paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer. In these situations (e.g., prepaid phone cards, customer loyalty programs), the Board noted in the Basis for Conclusions of ASU 2014-09[128] that the payment terms are not related to a financing arrangement between the parties and the costs of requiring an entity to account for a significant financing component would outweigh the benefits because an entity would need to continue to estimate when the goods or services will transfer to the customer.

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[123] Paragraph BC229 of ASU 2014-09.
[124] Paragraph BC230 of ASU 2014-09.
[125] Paragraph BC236 of ASU 2014-09.
[126] Paragraph BC235 of ASU 2014-09.
[127] Paragraph BC232(b) of ASU 2014-09.
[128] Paragraph BC233 of ASU 2014-09.

- A substantial amount of the consideration promised by the customer is variable and based on factors outside the control of the customer or entity. In these situations, the Board noted in the Basis for Conclusions of ASU 2014-09[129] that the primary purpose of the timing or terms of payment may be to allow for the resolution of uncertainties that relate to the consideration rather than to provide the customer or the entity with the significant benefit of financing. In addition, the terms or timing of payment in these situations may be to provide the parties with assurance of the value of the goods or services (e.g., an arrangement for which consideration is in the form of a sales-based royalty).
- The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing to either the customer or the entity (e.g., a payment is made in advance or in arrears in accordance with the typical payment terms of the industry or jurisdiction). In certain situations, the Board determined the purpose of the payment terms may be to provide the customer with assurance that the entity will complete its obligations under the contract, rather than to provide financing to the customer or the entity. Examples include a customer withholding a portion of the consideration until the contract is complete (illustrated in Example 27 below) or a milestone is reached, or an entity requiring a customer to pay a portion of the consideration up front in order to secure a future supply of goods or services. See Question 5-14 for further discussion.

As explained in the Basis for Conclusions of ASU 2014-09,[130] the Board decided not to provide an overall exemption from accounting for the effects of a significant financing component arising from advance payments. This is because ignoring the effects of advance payments could skew the amount and timing of revenue recognized if the advance payment is significant and the purpose of the payment is to provide the entity with financing. For example, an entity may require a customer to make advance payments in order to avoid obtaining the financing from a third party. If the entity obtained third-party financing, it likely would charge the customer additional consideration to cover the finance costs incurred. The Board decided that an entity's revenue should be consistent regardless of whether it receives the significant financing benefit from a customer or from a third party because, in either scenario, the entity's performance is the same.

In order to conclude that an advance payment does not represent a significant financing component, we believe an entity will need to support why the advance payment does not provide a significant financing benefit and describe its substantive business purpose. As a result, it is important that entities analyze all of the facts and circumstances in a contract. Example 29 below illustrates an entity's determination that a customer's advance payment represents a significant financing component, and Example 30 illustrates an entity's determination that a customer's advance payment does not represent a significant financing component.

The assessment of significance is made at the individual contract level. As noted in the Basis for Conclusions of ASU 2014-09,[131] the FASB decided that it would be an undue burden to require an entity to account for a financing component if the effects of the financing component are not significant to the individual contract but the combined effects of the financing components for a portfolio of similar contracts would be material to the entity as a whole.

When an entity concludes that a financing component is significant to a contract, in accordance with ASC 606-10-32-19, it determines the transaction price by applying an interest rate to the amount of promised consideration. The entity uses the same interest rate that it would use if it were to enter into a separate financing transaction with the customer. The interest rate has to reflect the credit characteristics of

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[129] Paragraph BC233 of ASU 2014-09.
[130] Paragraph BC238 of ASU 2014-09.
[131] Paragraph BC234 of ASU 2014-09.

the borrower in the contract, which could be the entity or the customer depending on who receives the financing. Using the risk-free rate or a rate explicitly stated in the contract that does not correspond with a separate financing rate would not be acceptable.[132] While this is not explicitly stated in the standard, we believe an entity should consider the expected term of the financing when determining the interest rate in light of current market conditions at contract inception. Also, ASC 606-10-32-19 is clear that an entity should not update the interest rate for changes in circumstances or market interest rates after contract inception.

How we see it

The standard requires that the interest rate be a rate similar to what the entity would have used in a separate financing transaction with the customer. Because most entities are not in the business of entering into freestanding financing arrangements with their customers, they may find it difficult to identify an appropriate rate. However, most entities perform some level of credit analysis before financing purchases for a customer, so they will have some information about the customer's credit risk. For entities that have different pricing for products depending on the time of payment (e.g., cash discounts), the standard indicates that the appropriate interest rate in some cases could be determined by identifying the rate that discounts the nominal amount of the promised consideration to the cash sales price of the good or service.

Entities likely will have to exercise significant judgment to determine whether a significant financing component exists when there is more than one year between the transfer of goods or services and the receipt of contract consideration. Entities will need to make sure that they sufficiently document their analyses to support their conclusions.

5.5.1 Examples

The standard includes several examples to illustrate these concepts. Example 26 illustrates a contract that contains a significant financing component because the cash selling price differs from the promised amount of consideration and there are no other factors present that would indicate that this difference arises for reasons other than financing. In this example, the contract also contains an implicit interest rate that is determined to be commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 26 — Significant Financing Component and Right of Return

606-10-55-227

An entity sells a product to a customer for $121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new, and the entity has no relevant historical evidence of product returns or other available market evidence.

606-10-55-228

The cash selling price of the product is $100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is $80.

[132] Paragraph BC239 of ASU 2014-09.

606-10-55-229

The entity does not recognize revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, revenue is recognized after three months when the right of return lapses.

606-10-55-230

The contract includes a significant financing component, in accordance with paragraphs 606-10-32-15 through 32-17. This is evident from the difference between the amount of promised consideration of $121 and the cash selling price of $100 at the date that the goods are transferred to the customer.

606-10-55-231

The contract includes an implicit interest rate of 10 percent (that is, the interest rate that over 24 months discounts the promised consideration of $121 to the cash selling price of $100). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs 606-10-55-22 through 55-29:

a. When the product is transferred to the customer, in accordance with paragraph 606-10-55-23.

Asset for right to recover product to be returned	$	80[(a)]		
Inventory			$	80

(a) This Example does not consider expected costs to recover the asset

b. During the three-month right of return period, no interest is recognized in accordance with paragraph 606-10-32-20 because no contract asset or receivable has been recognized.

c. When the right of return lapses (the product is not returned).

Receivable	$	100[(b)]		
Revenue			$	100
Cost of sales	$	80		
Asset for product to be returned			$	80

(b) The receivable recognized would be measured in accordance with Topic 310 on receivables. This Example does not consider the impairment accounting for the receivable

606-10-55-232

Until the entity receives the cash payment from the customer, interest income would be recognized consistently with the subsequent measurement guidance in Subtopic 835-30 on imputation of interest. The entity would accrete the receivable up to $121 from the time the right of return lapses until customer payment.

In Example 27, the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing. In this example, the customer withholds a portion of each payment until the contract is complete in order to protect itself from the entity failing to complete its obligations under the contract as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

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.

Example 28 illustrates two situations. In one, a contractual discount rate reflects the rate in a separate financing transaction. In the other, it does not.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 28 — Determining the Discount Rate

606-10-55-235

An entity enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is $1 million plus a 5 percent contractual rate of interest, payable in 60 monthly installments of $18,871.

Case A — Contractual Discount Rate Reflects the Rate in a Separate Financing Transaction

606-10-55-236

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent reflects the credit characteristics of the customer).

606-10-55-237

The market terms of the financing mean that the cash selling price of the equipment is $1 million. This amount is recognized as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.

Case B — Contractual Discount Rate Does Not Reflect the Rate in a Separate Financing Transaction

606-10-55-238

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest is significantly lower than the 12 percent interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than $1 million.

606-10-55-239

In accordance with paragraph 606-10-32-19, the entity determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 12 percent interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is $848,357 (60 monthly payments of $18,871 discounted at 12 percent). The entity recognizes revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.

Example 29 illustrates a contract with an advance payment from the customer that the entity concludes represents a significant benefit of financing. It also illustrates a situation in which the implicit interest rate does not reflect the interest rate in a separate financing transaction between the entity and its customer at contract inception, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 29 — Advance Payment and Assessment of Discount Rate

606-10-55-240

An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (that is, the performance obligation will be satisfied at a point in time). The contract includes 2 alternative payment options: payment of $5,000 in 2 years when the customer obtains control of the asset or payment of $4,000 when the contract is signed. The customer elects to pay $4,000 when the contract is signed.

606-10-55-241

The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

606-10-55-242

The interest rate implicit in the transaction is 11.8 percent, which is the interest rate necessary to make the 2 alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 606-10-32-19, the rate that should be used in adjusting the promised consideration is 6 percent, which is the entity's incremental borrowing rate.

606-10-55-243

The following journal entries illustrate how the entity would account for the significant financing component.

a. Recognize a contract liability for the $4,000 payment received at contract inception.

Cash	$ 4,000	
Contract Liability		$ 4,000

b. During the 2 years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 606-10-32-20) and accretes the contract liability by recognizing interest on $4,000 at 6 percent for 2 years.

Interest expense	$ 494[(a)]	
Contract liability		$ 494

(a) $494 = $4,000 contract liability x (6 percent interest per year for 2 years)

c. Recognize revenue for the transfer of the asset.

Contract liability	$	4,494		
Revenue			$	4,494

In Example 30, involving a contract with an advance payment from the customer, the entity determines that a significant financing component does not exist because the difference between the amount of promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 30 — Advance Payment

606-10-55-244

An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional $300. Customers electing to buy this service must pay for it upfront (that is, a monthly payment option is not available).

606-10-55-245

To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximize profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

606-10-55-246

In assessing the guidance in paragraph 606-10-32-17(c), the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Question 5-14

The standard states that a significant financing component does not exist if the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than providing financing. How broadly should this factor be applied? [30 March 2015 TRG meeting; agenda paper no. 30]

TRG members generally agreed that there likely will be significant judgment involved in determining whether either party is providing financing or the payment terms are for another reason. TRG members generally agreed that the Board did not seem to intend to create a presumption that a significant financing component exists if the cash selling price is different from the promised consideration.

The TRG agenda paper noted that although ASC 606-10-32-16 states the measurement objective for a significant financing component is to recognize revenue for the goods and services at an amount that reflects the cash selling price, this guidance is only followed when an entity has already determined that a significant financing component exists. The fact that there is a difference in the promised consideration and the cash selling price is not a principle for determining whether a significant financing component actually exists, it is only one factor to consider.

Many TRG members noted that it will require significant judgment in some circumstances to determine whether a transaction includes a significant financing component.

Question 5-15 **If the promised consideration is equal to the cash selling price, does a financing component exist?**
[30 March 2015 TRG meeting; agenda paper no. 30]

TRG members generally agreed that even if the list price, cash selling price and promised consideration of a good or service are all equal, an entity should not automatically assume that a significant financing component does not exist. This would be a factor to consider but would not be determinative.

As discussed above in Question 5-14, while ASC 606-10-32-16 states that the measurement objective for a significant financing component is to recognize revenue for the goods and services at an amount that reflects the cash selling price, this guidance is only followed when an entity has already determined that a significant financing component exists. The fact that there is no difference between the promised consideration and the cash selling price is not determinative in the evaluation of whether a significant financing component actually exists. It is a factor to consider, but it is not the only factor and is not determinative. As discussed above, an entity needs to consider all facts and circumstances in this evaluation.

The TRG agenda paper noted that the list price might not always equal the cash selling price (i.e., the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer, as defined in ASC 606-10-32-16). For example, if a customer offers to pay cash up front when the entity is offering "free" financing to customers, the customer that offers the upfront payment might be able to pay less than the list price. Determining a "cash selling price" may require judgment and the fact that an entity provides "zero interest financing" does not necessarily mean that the cash selling price is the same as the price another customer will pay over time. Entities should consider the cash selling price as compared to the promised consideration in making the evaluation based on the overall facts and circumstances of the arrangement.

This notion is consistent with the guidance in ASC 606-10-32-32 on allocating the transaction price to performance obligations based on standalone selling prices (see Section 6.1) that states that a contractually stated price or a list price for a good or service may be (but is not presumed to be) the standalone selling price of that good or service. The TRG agenda paper noted that it may be possible that a financing component exists but that it may not be significant. As discussed above in this Section, entities will need to apply judgment in determining whether the financing component is significant.

Question 5-16 **Does the standard preclude accounting for financing components that are not significant?**
[30 March 2015 TRG meeting; agenda paper no. 30]

TRG members generally agreed that the standard does not preclude an entity from deciding to account for a financing component that is not significant. For example, an entity may have a portfolio of contracts in which there is a mix of significant and insignificant financing components. An entity could choose to account for all of the financing components as significant in order to avoid having to apply different accounting methods to each.

An entity electing to apply the guidance on significant financing components for an insignificant financing should be consistent in its application to all similar contracts with similar circumstances.

Question 5-17 **The standard includes a practical expedient, which allows an entity to not assess a contract for a significant financing component if the period between the customer's payment and the entity's transfer of the goods or services is one year or less. How should entities consider whether the practical expedient applies to contracts with a single payment stream for multiple performance obligations?** [30 March 2015 TRG meeting; agenda paper no. 30]

TRG members generally agreed that entities will either apply an approach of allocating any consideration received (1) to the earliest good or service delivered or (2) proportionately to the goods and services, depending on the facts and circumstances.

The TRG agenda paper on this question provided an example of a telecommunications entity that enters into a two-year contract to provide a device at contract inception and related data services over the remaining term in exchange for 24 equal monthly installments. The former approach would allow the entity to apply the practical expedient because the period between transfer of the good or service and customer payment would be less than one year for both the device and the related services. This is because, in the example provided, the device would be "paid off" after five months. The latter approach would not allow an entity to apply the practical expedient because the device would be deemed to be paid off over the full 24 months (i.e., greater than one year).

The latter approach may be appropriate in circumstances similar to the example in the TRG agenda paper, when the cash payment is not directly tied to the earliest good or service delivered in a contract. The former approach may be appropriate when the cash payment is directly tied to the earliest good or service delivered. However, TRG members noted it may be difficult to tie a cash payment directly to a good or service because cash is fungible. Accordingly, judgment will be required based on the facts and circumstances.

Question 5-18 **If a significant financing component exists in a contract, how should an entity calculate the adjustment to revenue?** [30 March 2015 TRG meeting; agenda paper no. 30]

TRG members generally agreed that the standard does not contain guidance on how to calculate the adjustment to the transaction price due to a significant financing component. A financing component will be recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). Entities should consider guidance outside the revenue standard to determine the appropriate accounting (i.e., ASC 835-30 on interest).

Question 5-19 **How should an entity allocate a significant financing component when there are multiple performance obligations in a contract?** [30 March 2015 TRG meeting; agenda paper no. 30]

TRG members generally agreed that it may be reasonable for an entity to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. In doing so, the entity may analogize to other guidance in the standard that requires variable consideration or discounts to be allocated to one or more (but not all) performance obligations, if certain criteria are met (see Sections 6.3 and 6.4, respectively). However, attribution of a financing component to one (or some) of the performance obligations will require the use of judgment, especially because cash is fungible.

The standard is clear that when determining the transaction price in Step 3 of the model, the effect of financing is excluded from the transaction price prior to the allocation of the transaction price to performance obligations (which occurs in Step 4). However, stakeholders had questioned whether an adjustment for a significant financing component should ever be attributed to only one or some of the performance obligations in the contract, rather than to all of the performance obligations in the contract because the standard only includes examples in which there is a single performance obligation.

Question 5-20 **Is an entity required to evaluate whether a customer option that provides a material right includes a significant financing component? If so, are there any key factors an entity should consider when performing this evaluation?** [30 March 2015 TRG meeting; agenda paper no. 32]

See response to Question 4-17 in Section 4.6.

5.5.2 Financial statement presentation of financing component

The standard states the following on the financial statement presentation of the effects of financing:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

The Existence of a Significant Financing Component in the Contract

606-10-32-20

An entity shall present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income or interest expense is recognized only to the extent that a **contract asset** (or receivable) or a **contract liability** is recognized in accounting for a contract with a customer. In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

As discussed above, when a significant financing component exists in a contract, the transaction price is adjusted so that the amount recognized as revenue is the "cash selling price" of the underlying goods or services at the time of transfer. Essentially, a contract with a customer that has a significant financing component would be separated into a revenue component (for the notional cash sales price) and a loan component (for the effect of the deferred or advance payment terms).[133] Consequently, the accounting for a trade receivable arising from a contract that has a significant financing component should be comparable to the accounting for a loan with the same features.[134]

The amount allocated to the significant financing component should be presented separately from revenue recognized from contracts with customers. The financing component is recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). The interest income or expense is recognized over the financing period using the interest method described in ASC 835. The FASB noted in the Basis for Conclusions of ASU 2014-09[135] that an entity may present interest income as revenue only when interest income represents income from an entity's ordinary activities.

5.6 Noncash consideration

FASB amendments

In May 2016, the FASB issued ASU 2016-12 that clarified that the fair value of noncash consideration should be measured at contract inception when determining the transaction price. In addition, when the variability of noncash consideration is due to both its form (e.g., share of stock) and other reasons (e.g., performance considerations that affect the amount of noncash consideration), the constraint on variable consideration applies only to the variability for reasons other than the form.

[133] Paragraph BC244 of ASU 2014-09.

[134] Paragraph BC244 of ASU 2014-09.

[135] Paragraphs BC247 of ASU 2014-09.

The standard provides the following guidance for noncash consideration:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Noncash Consideration

606-10-32-21

To determine the **transaction price** for **contracts** in which a **customer** promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception (that is, the date at which the criteria in paragraph 606-10-25-1 are met).

606-10-32-22

If an entity cannot reasonably estimate the fair value of the noncash consideration, the entity shall measure the consideration indirectly by reference to the **standalone selling price** of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

606-10-32-23

The fair value of the noncash consideration may vary after contract inception because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer). Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price. If the fair value of the noncash consideration promised by a customer varies for reasons other than the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity shall apply the guidance in paragraphs 606-10-32-5 through 32-14 on variable consideration only to the variability resulting from reasons other than the form of the consideration.

606-10-32-24

If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.

Customer consideration might be in the form of goods, services or other noncash consideration (e.g., property, plant and equipment, a financial instrument). When an entity (i.e., the seller or vendor) receives, or expects to receive, noncash consideration, the fair value of the noncash consideration at contract inception is included in the transaction price.[136]

The Board decided[137] not to specify how the fair value of noncash consideration should be measured (e.g., the standard does not require an entity to apply ASC 820), in part, because the form of noncash consideration varies widely. Rather, the FASB observed that the concept of fair value exists in other parts of ASC 606 (e.g., the guidance on consideration payable to a customer) and that choosing the appropriate basis for measuring the fair value of noncash consideration requires judgment. If an entity cannot reasonably estimate the fair value of noncash consideration, it should measure the noncash consideration

[136] This statement applies only to transactions that are in the scope of the new guidance. Nonmonetary exchanges between entities in the same line of business that are arranged to facilitate sales to third parties (i.e., the entities involved in the exchange are not the end consumer) are excluded from the scope of the standard.

[137] Paragraph BC39 of ASU 2016-12.

indirectly by reference to the standalone selling price of the promised goods or services. For contracts with both noncash and cash consideration, an entity will only use fair value principles to measure the value of the noncash consideration and will look to other guidance within the revenue standard for the cash consideration. For example, in a contract for which an entity receives noncash consideration and a sales-based royalty, the entity would measure the fair value of the noncash consideration and look to the requirements within the revenue standard for sales-based royalties.

As noted in the Basis for Conclusions of ASU 2016-12,[138] the FASB concluded that the measurement date of the transaction price should not vary based on the nature of the promised consideration and indicated that measuring noncash consideration at contract inception is consistent with other aspects of the model for determining the transaction price and allocating the transaction price to performance obligations. For example, the transaction price is adjusted for a significant financing component (if present) using an appropriate discount rate at contract inception. Additionally, the transaction price is allocated to the identified performance obligations in a contract based on the standalone selling prices of goods or services at contract inception.

As a result of measuring noncash consideration at contract inception, any changes in the fair value of noncash consideration due to its form after contract inception are not recognized as revenue. Instead, an entity will apply the relevant GAAP for the form of the noncash consideration (e.g., ASC 320 if the noncash received is a debt or equity security) to determine whether and how any changes in fair value that occurred after contract inception should be recognized upon receipt of the noncash consideration.[139] For example, if the GAAP related to the form of the noncash consideration requires that asset to be measured at fair value, an entity will recognize a gain or loss (outside of revenue) upon receipt of the asset if the fair value of the noncash consideration increased or decreased since contract inception.

The initial classification of amounts related to noncash consideration will depend on the timing of receipt of the consideration in relation to an entity's performance. If an entity performs by transferring goods or services to a customer before the customer pays the noncash consideration or before payment of the noncash consideration is due, the FASB noted in the Basis for Conclusions of ASU 2016-12[140] that the entity will present the noncash consideration as a contract asset, excluding any amounts presented as a receivable. An entity should assess the contract asset or receivable for impairment.

The standard provides the following example of a transaction for which noncash consideration is received in exchange for services provided:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 31 — Entitlement to Noncash Consideration

606-10-55-248

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on January 1, 20X1, and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

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[138] Paragraph BC38 of ASU 2016-12.

[139] Paragraph BC40 of ASU 2016-12.

[140] Paragraph BC40 of ASU 2016-12.

606-10-55-249

In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

606-10-55-250

To determine the transaction price (and the amount of revenue to be recognized), the entity measures the estimated fair value of 5,200 shares at contract inception (that is, on January 1, 20X1). The entity measures its progress toward complete satisfaction of the performance obligation and recognizes revenue as each week of service is complete. The entity does not reflect any changes in the fair value of the 5,200 shares after contract inception in the transaction price. However, the entity assesses any related contract asset or receivable for impairment. Upon receipt of the noncash consideration, the entity would apply the guidance related to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception should be recognized.

How we see it

The requirement to measure the fair value of noncash consideration at contract inception will result in a change in practice for some entities. For example, under legacy GAAP, entities receiving customer equity as payment for goods or services generally measure the fair value of the equity when performance is complete (upon vesting).

Also, the concept of accounting for noncash consideration at the fair value of the noncash consideration received is a change from legacy GAAP, under which an entity first looks to the fair value of the goods or services surrendered and then to the fair value of the asset acquired if it was more clearly evident, unless certain exceptions are met. Under the new standard, the order is reversed. That is, an entity first considers the fair value of the noncash consideration received and only considers the fair value (i.e., selling price) of the goods or services surrendered if the fair value of what was received is not reasonably estimable. As a result, an entity's measurement of noncash consideration received from a customer may differ from the customer's measurement of the same noncash consideration granted. In addition, under legacy GAAP, if any of the exceptions for recognizing a transaction at fair value within ASC 845 are met, the noncash consideration surrendered would be measured at its carrying amount. This concept is not included in the new standard.

Further, the new guidance does not contain the prescriptive guidance for advertising barter transactions in legacy GAAP. Therefore, more judgment about the specific facts and circumstances will be necessary when accounting for advertising barter transactions.

The fair value of noncash consideration could change both because of the form of consideration (e.g., a change in the price of a share an entity is entitled to receive from a customer) and for reasons other than the form of consideration (e.g., a change in the exercise price of a share option because of the entity's performance). Under the standard, the variable consideration guidance applies only to variability resulting from reasons other than the form of consideration (i.e., there is uncertainty as to whether the entity will receive the noncash consideration if a future event occurs or does not occur). The FASB decided[141] that entities should apply the variable consideration guidance to the same types of variability, regardless of the form (i.e., cash or noncash) in which the consideration will be received.

[141] Paragraph BC252 of ASU 2014-09 and paragraph BC42 of ASU 2016-12.

The following example illustrates the accounting for noncash consideration with variability due to both the form of the consideration and performance (i.e., a reason other than the form of the consideration):

Illustration 5-1: Noncash consideration with variability due to both form and other reasons

An entity enters into a contract to construct a building in exchange for 100,000 options to purchase a share of the customer's stock with an exercise price of $15 per share. Under the terms of the arrangement, the exercise price of the options is affected by the entity's performance. If the entity completes the construction of the building within one year, the exercise price of the options is reduced to $13 per share.

At contract inception, the fair value of an option with a $15 exercise price is $5, and the fair value of an option with a $13 exercise price is $8. The entity determines that the probability of it finishing the building within one year is only 10% and that the most likely amount method better predicts the amount of variable consideration to which it will be entitled.

Using the fair value of noncash consideration at contract inception, the entity determines that the transaction price is $500,000 (100,000 options x $5 per option) and recognizes revenue as the services are performed.

After nine months, the entity determines there is an 80% probability that it will finish the building in the next three months and that the exercise price of the options will decline to $13 per share. After nine months, the fair value of an option with a $15 strike price is $10, and the fair value of an option with a $13 strike price is $13. The entity determines that the transaction price is $800,000 (100,000 options x $8 per option using the contract inception fair value of the option with a $13 strike price). The change in transaction price is due to a change in the estimate of variable consideration using the most likely amount method (i.e., the variability results from something other than the form of consideration). The change in transaction price does not include any change since contract inception in fair value due to the form of the consideration (i.e., the entity uses the fair value of the option with a $13 strike price determined at contract inception, not the fair value at the end month nine).

IASB differences

The IASB did not amend IFRS 15 to specify the measurement date of noncash consideration. As noted in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments), the IASB acknowledged that the use of a measurement date other than contract inception would not be precluded under IFRS. Consequently, it is possible that differences may exist in practice between IFRS and US GAAP entities. The IASB noted that legacy IFRS does not contain specific requirements about the measurement date for noncash consideration. Therefore, IFRS 15 is not expected to create more diversity than presently exists.

5.7 Consideration paid or payable to a customer

Many entities make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

The standard provides the following guidance for consideration paid or payable to a customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Consideration Payable to a Customer

606-10-32-25

Consideration payable to a **customer** includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the **transaction price** and, therefore, of **revenue** unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

606-10-32-26

If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

606-10-32-27

Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

a. The entity recognizes revenue for the transfer of the related goods or services to the customer.

b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

The standard states that an entity should account for the consideration payable to a customer, regardless of whether the purchaser receiving the consideration is a direct or indirect customer of the entity. This includes consideration payable to any purchasers of the entity's products at any point along the distribution chain. This would include entities that make payments to the customers of resellers or distributors that purchase directly from the entity (e.g., manufacturers of breakfast cereals offer coupons to consumers, even though their direct customers are the grocery stores that sell to consumers). The requirements also apply to entities that derive revenue from sales of services, as well as entities that derive revenue from sales of goods.

Question 5-21 **Who is considered an entity's customer when applying the guidance on consideration payable to a customer?** [30 March 2015 TRG meeting; agenda paper no. 28 and 13 July 2015 TRG meeting; agenda paper no. 37]

TRG members generally agreed that this guidance should be applied to all payments made to entities/customers in the distribution chain for that contract. However, they agreed there also could be situations in which the guidance should apply to payments made to any customer of an entity's customer outside the distribution chain if both parties are considered the entity's customers. For example, in an arrangement with a principal, an agent and an end customer, an agent may conclude that its only customer is the principal, or it may conclude that it has two customers — the principal and the end customer. Regardless of this assessment, an agent's payment to a principal's end customer that was contractually required based on an agreement between the entity (agent) and the principal would represent consideration payable to a customer. Absent similar contract provisions that clearly indicate when an amount is consideration payable, TRG members generally agreed that agents will need to evaluate their facts and circumstances to determine whether payments they make to an end customer should be considered a reduction of revenue or a marketing expense.

5.7.1 Classification of the different types of consideration paid or payable to a customer

To determine the appropriate accounting treatment, an entity must first determine whether the consideration paid or payable to a customer is a payment for a distinct good or service, a reduction of the transaction price or a combination of both.

For a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct (as discussed in Section 4.2.1). However, if the payment to the customer is in excess of the fair value of the distinct good or service received, the entity must account for such excess as a reduction of the transaction price.

5.7.2 Forms of consideration paid or payable to a customer

Consideration paid or payable to customers commonly takes the form of discounts and coupons, among other things. Further, the promise to pay the consideration might be implied by the entity's customary business practice.

Because consideration paid to a customer can take many different forms, entities will have to carefully evaluate each transaction to determine the appropriate treatment of such amounts. Some common examples of consideration paid to a customer include:

Slotting fees — Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Those shelves can be physical (i.e., in a building where the store is located) or virtual (i.e., they represent space in an internet reseller's online catalog). Generally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

Cooperative advertising arrangements — In some arrangements, a vendor agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the vendor's products. The determination of whether the payment from the vendor is in exchange for a distinct good or service at fair value will depend on a careful analysis of the facts and circumstances of the contract.

Buy downs or margin/price protection — A vendor may agree to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the vendor's products. Normally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

Coupons and rebates — An indirect customer of a vendor may receive a refund of a portion of the purchase price of the product or service acquired by returning a form to the retailer or the vendor. Generally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

"Pay to play" arrangements — In some arrangements, an entity pays an up-front fee to the customer in order to obtain a new contract. In most cases, these payments are not associated with any distinct good or service to be received from the customer and should be treated as a reduction of the transaction price.

Purchase of goods or services — Entities often enter into supplier-vendor arrangements with their customers in which the customers provide them with a distinct good or service. For example, a software entity may buy its office supplies from one of its software customers. In such situations, the entity has to carefully determine whether the payment made to the customer is solely for the goods and services received, or whether part of the payment is actually a reduction of the transaction price for the goods and services the entity is transferring to the customer.

How we see it

The new guidance for consideration payable to a customer is similar to legacy GAAP. However, determining whether a good or service is "distinct" may result in an entity reaching a different conclusion than under legacy GAAP, which requires the vendor to receive an "identifiable benefit" from the customer that is sufficiently separable from the customer's purchases of the vendor's products in order to treat the consideration payable to a customer as anything other than a reduction of revenue.

Question 5-22 **Which payments to a customer are in the scope of the guidance on consideration payable to a customer?** [30 March 2015 TRG meeting; agenda paper no. 28 and 13 July 2015 TRG meeting; agenda paper no. 37]

TRG members generally agreed that an entity may not have to separately analyze each payment to a customer if it is apparent that the payment is for a distinct good or service acquired in the normal course of business at a market price. However, if the business purpose of a payment to a customer is unclear or the goods or services are acquired in a manner that is inconsistent with market terms other entities would receive when purchasing the customer's good or services, the payment should be evaluated under this guidance.

In the Basis for Conclusions of ASU 2014-09,[142] the FASB noted that the amount of consideration received from a customer for goods or services, and the amount of any consideration paid to that customer for goods or services, could be linked even if they are separate events, similar to legacy GAAP.

When legacy GAAP on this topic was written, the intent was for the guidance to have a very broad application. This has caused some transactions that likely were not contemplated to be linked to revenue transactions to be in the scope of the guidance. Legacy GAAP requires completely separate transactions to be considered when applying the guidance. For example, if an entity makes contributions to a charitable organization and the charity is also a customer of the entity, the contributions are likely within the scope of legacy GAAP guidance.

[142] Paragraph BC257 of ASU 2014-09.

5.7.3 Timing of recognition of consideration paid or payable to a customer

If the consideration paid or payable to a customer is a discount or refund for goods or services provided to a customer, the guidance on consideration payable to a customer says this reduction of the transaction price (and thus revenue) should be recognized at the later of when the entity transfers the promised goods or services to the customer or the entity promises to pay the consideration. For example, if goods subject to a discount through a coupon are already delivered to the retailers, the discount would be recognized when the coupons are issued. However, if a coupon is issued that can be used on a new line of products that have not yet been sold to retailers, the discount would be recognized upon sale of the product to a retailer.

However, to determine the appropriate timing of recognition of consideration payable to a customer, entities also will need to consider the guidance on variable consideration. That is, the standard's definition of variable consideration is broad and includes amounts such as coupons or other forms of credits that can be applied to the amounts owed to an entity by the customer. That guidance requires that all potential variable consideration be considered and reflected in the transaction price at inception and reassessed as the entity performs. In other words, if an entity has a history of providing this type of consideration to its customers, the guidance on estimating variable consideration would require that such amounts be considered at the inception of the contract, even if the entity has not yet provided or explicitly promised this consideration to the customer.

The TRG discussed[143] the potential inconsistency between the consideration payable guidance and the variable consideration guidance that arises because the guidance specific to "consideration payable to a customer" states that such amounts should not be recognized as a reduction of revenue until the *later* of when the related sales are recognized or the entity makes the promise to provide such consideration. A literal reading of this guidance seems to suggest that an entity should not anticipate that it may offer these types of programs, even if it has a history of doing so, and should only recognize the effect of these programs at the later of when the entity transfers the promised goods or services or makes a promise to pay the customer. Members of the TRG generally agreed[144] that if an entity has a history of providing this type of consideration to customers, the guidance on estimating variable consideration would require the entity to consider such amounts at the contract's inception when the transaction price is estimated, even if the entity has not yet provided or promised to provide this consideration to the customer. If the consideration paid or payable to a customer includes variable consideration in the form of a discount or refund for goods or services provided, an entity would use either the expected value method or most likely amount method to estimate the amount to which the entity expects to be entitled and apply the constraint to the estimate (see Section 5.2 for further discussion) to determine the effect on the transaction price of the discount or refund.

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[143] 13 July 2015 TRG meeting; agenda paper no. 37.
[144] 13 July 2015 TRG meeting; agenda paper no. 44.

The standard includes the following example of consideration paid to a customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 32 — Consideration Payable to a Customer

606-10-55-252

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least $15 million of products during the year. The contract also requires the entity to make a nonrefundable payment of $1.5 million to the customer at the inception of the contract. The $1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

606-10-55-253

The entity considers the guidance in paragraphs 606-10-32-25 through 32-27 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 606-10-32-25, the $1.5 million payment is a reduction of the transaction price.

606-10-55-254

The entity applies the guidance in paragraph 606-10-32-27 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognizes revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 percent ($1.5 million ÷ $15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognizes revenue of $1.8 million ($2.0 million invoiced amount − $0.2 million of consideration payable to the customer).

How we see it

TRG members' general agreement that entities will need to consider the guidance on variable consideration to determine the appropriate timing of recognition of consideration payable to a customer may result in a change in practice for some entities. TRG members generally agreed[145] that the "later of" guidance for consideration payable to a customer in the new standard would be applied in more limited circumstances than under legacy GAAP.

5.8 Nonrefundable up-front fees

In certain circumstances, entities may receive payments from customers before they provide the contracted service or deliver a good. Up-front fees generally relate to the initiation, activation or setup of a good to be used, or a service to be provided, in the future. Up-front fees also may be paid to grant access to, or to provide a right to use, a facility, product or service. In many cases, the up-front amounts paid by the customer are nonrefundable.

[145] 13 July 2015 TRG meeting; agenda paper no. 44.

The standard provides the following guidance for nonrefundable up-front fees:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Nonrefundable Upfront Fees (and Some Related Costs)

606-10-55-50

In some **contracts**, an entity charges a **customer** a nonrefundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, activation fees in telecommunication contracts, setup fees in some service contracts, and initial fees in some supply contracts.

606-10-55-51

To identify **performance obligations** in such contracts, an entity should assess whether the fee relates to the transfer of a promised good or service. In many cases, even though a nonrefundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer (see paragraph 606-10-25-17). Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognized as **revenue** when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right as described in paragraph 606-10-55-42.

606-10-55-52

If the nonrefundable upfront fee relates to a good or service, the entity should evaluate whether to account for the good or service as a separate performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

606-10-55-53

An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity should assess whether costs incurred in setting up a contract have resulted in an asset that should be recognized in accordance with paragraph 340-40-25-5.

Entities must evaluate whether nonrefundable up-front fees relate to the transfer of a good or service. In many situations, an up-front fee represents an advance payment for future goods or services. In addition, the existence of a nonrefundable up-front fee may indicate that the contract includes a renewal option for future goods and services at a reduced price (if the customer renews the agreement without the payment of an additional up-front fee), which an entity would need to assess to determine whether the option is a material right (i.e., another performance obligation in the contract) (see Section 4.6). If the entity concludes that the nonrefundable up-front fee does not provide a material right, the fee would be part of the consideration allocable to the goods or services in the contract and would be recognized as the good or service to which the consideration was allocated is transferred to the customer. If an entity concludes that the nonrefundable up-front fee provides a material right, the amount of the fee allocated to the material right would be recognized over the period of benefit of the fee, which may be the estimated customer life.

The following illustration depicts the allocation of a nonrefundable up-front fee determined to be a material right:

Illustration 5-2: Nonrefundable up-front fees

A customer signs a one-year contract with a health club and is required to pay both a nonrefundable initiation fee of $150 and an annual membership fee in monthly installments of $40. At the end of each year, the customer can renew the contract for an additional year without paying an additional initiation fee. The customer is then required to pay an annual membership fee in monthly installments of $40 for each renewal period. The club's activity of registering the customer does not transfer any service to the customer and, therefore, is not a performance obligation. By not requiring the customer to pay the up-front membership fee again at renewal, the club is effectively providing a discounted renewal rate to the customer.

The club determines that the renewal option is a material right because it provides a renewal option at a lower price than the range of prices typically charged for new customers, and therefore, it is a separate performance obligation. Based on its experience, the club determines that its customers, on average, renew their annual memberships twice before terminating their relationship with the club. As a result, the club determines that the option provides the customer with the right to two annual renewals at a discounted price. In this scenario, the club would allocate the total transaction consideration of $630 ($150 up-front membership fee + $480 ($40 x 12 months)) to the identified performance obligations (monthly services for the one year contract and renewal option) based on the relative standalone selling price method. The amount allocated to the renewal option would be recognized as each of the two renewal periods is either exercised or forfeited.

Alternatively, the club could value the option by "looking through" to the optional goods and services using the practical alternative provided in ASC 606-10-55-45 (see Section 6.1.5). In that case, the club would determine that the total hypothetical transaction price (for purposes of allocating the transaction price to the option) is the sum of the up-front fee plus three years of service fees (i.e., $150 + $1,440) and would allocate that amount to all of the services expected to be delivered, or 36 months of membership (or $44.17 per month). Therefore, the total consideration in the contract of $630 would be allocated to the 12 months of service ($530 ($44.17 x 12 months)) with the remaining amount being allocated to the renewal option ($100 ($630 – 530)). The amount allocated to the renewal option ($100) would be recognized as revenue over each renewal period. One acceptable approach would be to reduce the initial $100 deferred revenue balance for the material right by $4.17 each month ($100 / 24 months remaining), assuming the estimated renewal period of two years remains unchanged.

See Sections 4.6 and 6.1.5 for a more detailed discussion of the treatment of options (including the practical alternative allowed under ASC 606-10-55-45) and Sections 6.1 and 6.2 for a discussion of estimating standalone selling prices and allocating consideration using the relative standalone selling price method.

Question 5-23 **Over what period should an entity recognize a nonrefundable up-front fee (e.g., fees paid for membership to a health club or buying club, activation fees for phone, cable or internet services) that does not relate to the transfer of a good or service?** [30 March 2015 TRG meeting; agenda paper no. 32]

TRG members generally agreed that the period over which a nonrefundable up-front fee will be recognized depends on whether the fee provides the customer with a material right with respect to future contract renewals. For example, if an entity that charges a $50 one-time activation fee to provide $100 of services to a customer on a month-to-month basis concludes that the activation fee provides a material right, the fee would be recognized over the service period during which the customer is expected to benefit from not having to pay an activation fee upon renewal of service, which may be the estimated customer life in some situations. If the entity concludes that the activation fee does not provide a material right, the fee would be recognized over the contract term (i.e., one month).

5.9 Changes in the transaction price

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Changes in the Transaction Price

606-10-32-42

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

Changes in the transaction price can occur for various reasons. See Section 6.5 for additional guidance on accounting for a change in transaction price.

6 Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). The Board noted in the Basis for Conclusions of ASU 2014-09[146] that an allocation based on standalone selling prices most often faithfully depicts the different margins that may apply to promised good or services. The standard includes the following allocation guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocating the Transaction Price to Performance Obligations

606-10-32-28

The objective when allocating the transaction price **is for an entity to allocate the transaction price to each** performance obligation **(or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the** customer**.**

606-10-32-29

To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the **contract** on a relative **standalone selling price** basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

606-10-32-30

Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.

When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, as discussed further below, there are some exceptions. For example, an entity could allocate variable consideration to a single performance obligation in some situations. The standard also contemplates the allocation of any discount in a contract to only certain performance obligations, if specified criteria are met. An entity would not apply the allocation guidance if the contract only has one performance obligation (that is not made up of a series of distinct goods and services and includes variable consideration).

[146] Paragraph BC266 of ASU 2014-09.

6.1 Determining standalone selling prices

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. Under the standard, this is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception.

Under the model, the observable price of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price. The standard provides the following guidance on determining standalone selling prices, which may include estimation:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocation Based on Standalone Selling Prices

606-10-32-31

To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.

606-10-32-32

The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

606-10-32-33

If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.

606-10-32-34

Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

a. Adjusted market assessment approach — An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

b. Expected cost plus a margin approach — An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

c. Residual approach — An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:

1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).

2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

606-10-32-35

A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

Standalone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete. For example, if an entity determines the standalone selling price for a promised good, and before it can finish manufacturing and deliver that good, the underlying cost of the materials doubles, the entity would not revise its standalone selling price for purposes of this contract. However, for future contracts involving the same good, the entity would need to determine whether the change in circumstances (i.e., the significant increase in the cost to produce the good) warrants a revision in the standalone selling price. If so, the entity would use that revised price for future allocations in future contracts (see Section 6.1.3).

Further, if the contract is modified, and the modification is treated as a termination of the existing contract and the creation of a new contract, the entity would update its estimates of standalone selling prices at the time of the modification. If the contract is modified, and the modification is treated as a separate contract, the accounting for the original contract would not be affected (and the standalone selling prices of the underlying goods and services would not be updated), but the standalone selling prices of the distinct goods or services of the new, separate contract would have to be determined at the time of the modification.

How we see it

The requirement to estimate a standalone selling price if a directly observable selling price is not available will not be a new concept for entities that have historically applied the multiple-element arrangements guidance in ASC 605-25. The new guidance on estimating a standalone selling price is generally consistent with ASC 605-25 except that it does not require an entity to consider a hierarchy of evidence to make this estimate.

Some entities have adopted the provisions of ASC 605-25 by developing estimates of selling prices for elements within an arrangement that may exhibit "highly variable" pricing as described in Section 6.1.2. The new standard may allow those entities to revert to a residual approach.

The requirement to estimate a standalone selling price may be a significant change for entities that have historically followed the software revenue recognition guidance in ASC 985-605. That literature has a different threshold for determining the standalone selling price, requiring observable evidence and not management estimates. Some of these entities may find it difficult to determine a standalone selling price, particularly for goods or services that are never sold separately (e.g., specified upgrade rights for software). In certain circumstances, an entity may be able to estimate the standalone selling price of a performance obligation using a residual approach (see Section 6.1.2). In these cases, the results would likely be similar to circumstances when legacy GAAP required a residual approach.

6.1.1 Factors to consider when estimating the standalone selling price

To estimate the standalone selling price (if not readily observable), an entity may consider the stated prices in the contract, but the standard says an entity cannot presume that a contractually stated price or a list price for a good or service is the standalone selling price. As stated in ASC 606-10-32-33 above, an "entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity" to estimate a standalone selling price. An entity also will need to maximize the use of observable inputs in its estimate. This is a very broad requirement that will require an entity to consider a variety of data sources.

The following list, which is not all inclusive, provides examples of market conditions to consider:

- Potential limits on the selling price of the product
- Competitor pricing for a similar or identical product
- Market awareness of and perception of the product
- Current market trends that will likely affect the pricing
- The entity's market share and position (e.g., the entity's ability to dictate pricing)
- Effects of the geographic area on pricing
- Effects of customization on pricing
- Expected life of the product, including whether significant technological advances are expected in the market in the near future

Examples of entity-specific factors include:

- Profit objectives and internal cost structure
- Pricing practices and pricing objectives (including desired gross profit margin)
- Effects of customization on pricing
- Pricing practices used to establish pricing of bundled products
- Effects of a proposed transaction on pricing (e.g., the size of the deal, the characteristics of the targeted customer)
- Expected life of the product, including whether significant entity-specific technological advances are expected in the near future

To document its estimated standalone selling price, an entity should describe in detail what information it considered (e.g., the factors listed above), especially if there is limited observable data or none at all.

6.1.2 Possible estimation approaches

ASC 606-10-32-34 above discusses three estimation approaches: (1) the adjusted market assessment approach, (2) the expected cost plus a margin approach and (3) a residual approach, all of which are discussed further below. When applying the standard, an entity may need to use a different estimation approach for each of the distinct goods or services underlying the performance obligations in a contract. In addition, an entity may need to use a combination of approaches to estimate the standalone selling prices of goods or services promised in a contract if two of more of those goods and services have highly variable or uncertain standalone selling prices. This may be applicable when an entity is using the residual approach to allocate consideration because there are two or more goods or services with highly variable or uncertain standalone selling prices but at least one of the goods or services in the contract has an observable standalone selling price. For example, the Board noted in the Basis for Conclusions of ASU 2014-09[147] (and discussed further below) that an entity in such a situation might apply the residual approach to estimate the aggregate of the standalone selling prices for all the promised goods or services with highly variable or uncertain standalone selling prices and then use another approach to estimate the standalone selling prices of each of those promised goods or services.

Further, these are not the only estimation approaches permitted. The standard allows any reasonable estimation approach as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services and customers.

In some cases, an entity may have sufficient observable data to determine the standalone selling price. For example, an entity may have sufficient standalone sales of a particular good or service that give it persuasive evidence of the standalone selling price of a particular good or service. In such situations, no estimation would be necessary.

If an entity does not have sufficient standalone sales data to determine the standalone selling price based solely on those sales, it must maximize the use of whatever observable inputs it has available to make its estimate. In other words, an entity should not disregard any observable inputs when estimating the standalone selling price of a good or service. An entity should consider all factors contemplated in negotiating the contract with the customer and the entity's normal pricing practices factoring in the most objective and reliable information that is available. While many entities may have robust practices in place regarding the pricing of goods and services, some entities may need to improve their processes to develop estimates of standalone selling prices.

The standard includes the following estimation approaches:

Adjusted market assessment approach — This approach focuses on the amount that the entity believes the market in which it sells goods or services is willing to pay for a good or service. For example, an entity might refer to competitor prices for similar goods and services and adjust those prices as necessary to reflect the entity's costs and margins. When using the adjusted market assessment approach, an entity should consider market conditions, such as those listed in Section 6.1.1. Applying this approach will likely be easiest when an entity has sold the good or service for a period of time (so it has data about customer demand) or a competitor offers similar goods or services that the entity can use as a basis for its analysis. Applying this approach may be difficult when an entity is selling an entirely new good or service because it may be difficult to anticipate market demand. In these situations, entities may want to use the market assessment approach, with adjustments as necessary to reflect the entity's costs and margins, in combination with

[147] Paragraph BC272 of ASU 2014-09.

other approaches to maximize the use of observable inputs (e.g., using competitor pricing, adjusted based on the market assessment approach combined with an entity's planned internal pricing strategies if the performance obligation has never been sold separately).

Expected cost plus margin approach — This approach focuses more on internal factors (e.g., the entity's cost basis) but has an external component as well. That is, the margin included in this approach must reflect the margin the market would be willing to pay, not just the entity's desired margin. The margin may have to be adjusted for differences in products, geographies, customers and other factors. The expected cost plus margin approach may be useful in many situations, especially when the performance obligation has a determinable, direct fulfillment cost (e.g., a tangible product or an hourly service). However, this approach may be less helpful when there are no clearly identifiable direct fulfillment costs or the amount of those costs is unknown (e.g., a new software license or specified upgrade rights).

Residual approach — This approach allows an entity to estimate the standalone selling price of a promised good or service as the difference between the total transaction price and the observable (i.e., not estimated) standalone selling prices of other promised goods or services in the contract, provided one of two criteria are met. Because the standard indicates that this approach only can be applied to contracts with multiple promised goods or services when the selling price of one or more goods or services is unknown, either because the historical selling price is highly variable or because the goods or services have not yet been sold, we anticipate the use of this approach likely will be limited. However, allowing entities to use a residual technique will provide relief to entities that rarely or never sell goods or services on a standalone basis, such as entities that sell intellectual property only with physical goods or services.

An example would be an entity that frequently sells software, professional services and maintenance bundled together at prices that vary widely and also sells the professional services and maintenance individually at relatively stable prices. The FASB indicated that it may be appropriate to estimate the standalone selling price for the software as the difference between the total transaction price and the observable selling prices of the professional services and maintenance. See Example 34, Cases B and C, in Section 6.4 for examples of when the residual approach may or may not be appropriate.

As mentioned above, the Board clarified in the Basis for Conclusions of ASU 2014-09[148] that an entity could also use the residual approach if there are two or more goods or services in the contract with highly variable or uncertain standalone selling prices, provided at least one of the other promised goods or services in the contract has an observable standalone selling price. The Board observed that in such an instance, an entity may need to use a combination of techniques to estimate the standalone selling prices. For example, an entity may apply the residual approach to estimate the aggregate of the standalone selling prices for all of the promised goods or services with highly variable or uncertain standalone selling prices, but then use another approach (e.g., adjusted market assessment, expected cost plus margin) to estimate the standalone selling prices of each of those promised goods or services with highly variable or uncertain standalone selling prices.

[148] Paragraph BC272 of ASU 2014-09.

The standard includes the following example in which two estimation approaches are used to estimate standalone selling prices of two different goods in a contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 33 — Allocation Methodology

606-10-55-256

An entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately, and, therefore the standalone selling price is directly observable. The standalone selling prices of Products B and C are not directly observable.

606-10-55-257

Because the standalone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the standalone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximizes the use of observable inputs (in accordance with paragraph 606-10-32-33). The entity estimates the standalone selling prices as follows:

Product	Standalone selling price	Method
Product A	$ 50	Directly observable (see paragraph 606-10-32-32)
Product B	25	Adjusted market assessment approach (see paragraph 606-10-32-34(a))
Product C	75	Expected cost plus a margin approach (see paragraph 606-10-32-34(b))
Total	$ 150	

606-10-55-258

The customer receives a discount for purchasing the bundle of goods because the sum of the standalone selling prices ($150) exceeds the promised consideration ($100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs (in accordance with paragraph 606-10-32-37) and concludes that it does not. Consequently, in accordance with paragraphs 606-10-32-31 and 606-10-32-36, the discount is allocated proportionately across Products A, B, and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated transaction price	
Product A	$ 33	($50 ÷ $150 × $100)
Product B	17	($75 ÷ $150 × $100)
Product C	50	($75 ÷ $150 × $100)
Total	$ 100	

Given the flexibility provided by the guidance, it is both appropriate and necessary for entities to tailor the approach(es) used to estimate standalone selling prices to their specific facts and circumstances. Regardless of whether an entity uses a single approach or a combination of approaches to estimate the standalone selling prices, the entity should evaluate whether the resulting allocation of the transaction price is consistent with the overall allocation objective of ASC 606-10-32-28 and the guidance on estimating standalone selling prices above.

In accordance with the standard, an entity must make a reasonable estimate of the standalone selling price for the distinct good or service underlying each performance obligation if an observable selling price is not readily available. In developing this requirement, the FASB believed that, even in instances in which limited information is available, entities should have sufficient information to develop a reasonable estimate.

How we see it

Estimating standalone selling price may require a change in practice. Entities will no longer follow the hierarchy in legacy ASC 605-25 guidance that requires them to consider VSOE, then third-party evidence and then best estimate of selling price. In addition, entities that follow legacy ASC 985-605 will no longer be required to establish VSOE of fair value based on a significant majority of their transactions. As a result, we expect that entities may use different approaches than under legacy GAAP to estimate standalone selling prices. However, because these estimates may have limited underlying observable data, it will be important for entities to have robust documentation to demonstrate the reasonableness of the calculations they make in estimating standalone selling prices. It isn't clear how much an entity's estimate of standalone selling price will change as a result of applying the new guidance.

6.1.3 Updating estimated standalone selling prices

The standard does not directly address how frequently estimated standalone selling prices must be updated. Instead, it indicates that an entity must make this estimate for each distinct good or service underlying each performance obligation in a contract with a customer (suggesting constant updating). In practice, we anticipate that entities will be able to consider their facts and circumstances in order to determine how frequently they will need to update their estimates. For example, if the information used to estimate the standalone selling price for similar transactions has not changed, an entity may determine that it is reasonable to use the previously determined standalone selling price. However, so that changes in circumstances are reflected in the estimate in a timely manner, we anticipate that an entity would formally update the estimate on a regular basis (e.g., quarterly, semiannually). The frequency of updates should be based on the facts and circumstances of the distinct good or service underlying each performance obligation for which the estimate is made. An entity should use current information each time it develops or updates its estimate, and the approach used to estimate standalone selling price should not change (i.e., an entity must use a consistent approach) unless facts and circumstances change.

6.1.4 Additional considerations for determining the standalone selling price

While this is not stated explicitly in the standard, we anticipate that a single good or service could have more than one standalone selling price. That is, the entity may be willing to sell goods or services at different prices to different customers. Further, an entity may use different prices in different geographies or in markets where it uses different methods to distribute its products (e.g., it may use a distributor or reseller rather than selling directly to the end customer) or for other reasons (e.g., different cost structures or strategies in different markets). Accordingly, an entity may need to stratify its analysis to determine its standalone selling price for each class of customer, geography and/or market, as applicable.

In addition, it may be appropriate, depending on the facts and circumstances, for an entity to develop a reasonable range for its estimated standalone selling price rather than a single estimate. See discussion in Question 6-3 below.

Question 6-1 **When estimating the standalone selling price, does an entity have to consider historical pricing for the sale of the good or service involved?**

Yes, we believe that an entity should consider historical pricing in all circumstances but it may not be determinative. Historical pricing is likely an important data point that reflects both market conditions and entity-specific factors and can provide supporting evidence about the reasonableness of management's estimate. For example, if management determines based on its pricing policies and competition in the market that the standalone selling price of its good or service is X, historical transactions within a reasonable range of X would provide supporting evidence for management's estimate. However, if historical pricing was only 50% of X, this may indicate that historical pricing is no longer relevant due to changes in the market, for example, or that management's estimate is flawed.

Depending on the facts and circumstances, an entity may conclude that other factors such as internal pricing policies are more relevant to its determination of standalone selling price. When historical pricing was established using the entity's normal pricing policies and procedures, it is more likely that this information will be relevant in the estimation.

If the entity has sold the product separately or has information on competitor pricing for a similar product, the entity likely would find historical data relevant to its estimate of standalone selling prices, among other factors. In addition, we believe it may be appropriate for entities to stratify standalone selling prices based on the type or size of customer, the amount of product or services purchased, the distribution channel, the geographic location or other factors.

Question 6-2 **When using an expected cost plus margin approach to estimate standalone selling price, how should an entity determine an appropriate margin?**

When an entity uses the expected cost plus margin approach, it is important for the entity to use an appropriate margin. Determining an appropriate margin will likely require the use of significant judgment and will involve the consideration of many market conditions and entity-specific factors discussed above. For example, it would not be appropriate to determine that the entity's estimate of standalone selling price is cost plus a 30% margin when a review of market conditions demonstrates that customers are only willing to pay the equivalent of cost plus a 12% margin for a comparable product. Similarly, it would be inappropriate to determine that cost plus a specified margin represents the standalone selling price if competitors are selling a comparable product at twice the determined estimate. Further, the determined margin will likely have to be adjusted for differences in products, geographic location, customers and other factors.

Question 6-3 **When estimating the standalone selling price of a good or service, can an entity estimate a range of prices or will it have to identify a point estimate?**

We believe it is reasonable for an entity to use a range of prices to estimate the standalone selling price of a good or service. That is, we do not believe that an entity would be required to determine a point estimate for each estimated standalone selling price if a range is a more practical means of estimating the standalone selling price for a good or service. While the standard doesn't address ranges of estimates, using a range of prices would not be inconsistent with the objective of the standard, which is to allocate the transaction price to each performance obligation in "an amount that depicts the amount of consideration for which the entity expects to be entitled in exchange for transferring the promised good or service to the customer." The only requirements in the standard are that an entity maximize its use of observable inputs and apply the estimation approaches consistently. The use of a range would be consistent with these principles as well.

Under legacy multiple element guidance, VSOE of selling price can be established when a large portion of the standalone sales fall within a narrow range (e.g., when the vendor can demonstrate that the pricing of 80% of the standalone sales fall within a range of plus or minus 15% from the midpoint of the range). We believe the use of a similar range would be acceptable for determining estimates of standalone selling prices under the standard because it is consistent with the standard's principle that an entity must maximize its use of observable inputs. If the entity has established a reasonable range for the estimated standalone selling prices and the stated contractual price fell within that range, it may be appropriate to use the stated contractual price as the standalone selling price. However, if the stated contractual price for the good or service was outside of the range, the standalone selling price would need to be adjusted to a point within the established range in order to allocate the transaction price on a relative standalone selling price basis. In these situations, the entity would need to determine which point in the range is most appropriate to use (e.g., the midpoint of the range or the outer limit nearest to the stated contractual price). We believe entities should establish a policy regarding the point in the range that will be used (e.g., low point, midpoint) and apply that policy consistently.

While the use of a range may be appropriate for estimating standalone selling price, we believe that some approaches to identifying this range do not meet the requirements of the guidance. For example, it wouldn't be appropriate for an entity to determine a range by estimating a single price point for standalone selling price and then adding an arbitrary range on either side of that point estimate or by taking the historical prices and expanding the range around the midpoint until a significant portion of the historical transactions fall within that band.

To illustrate, assume that an entity determines that 60% of its historical prices fall within +/-15% of $100 (i.e., $85 to $115). However, the vendor determines that 80% of the historical prices fall within +/- 30% of $100 and proposes a range for the standalone selling price estimate of $70 to $130. The wider the range necessary to capture a high proportion of historical transactions, the less relevant the range is in terms of providing a useful data point for estimating standalone selling prices.

Conversely, if management's analysis of market conditions and entity-specific factors resulted in management determining that the best estimate of the standalone selling price is $85 to $115, we believe the historical data showing that 60% of the transactions fall within that range, while likely not determinative, could be used as supporting evidence for management's conclusion because it is consistent with the standard's principle that an entity must maximize its use of observable inputs. In this case, management should analyze the transactions that fall outside the range to determine whether they have similar characteristics and should be evaluated as a separate class of transactions with a different estimated selling price.

6.1.5 Measurement of options that are separate performance obligations

An entity that determines that an option is a separate performance obligation (because the option provides the customer with a material right, as discussed further in Section 4.6) has to determine the standalone selling price of the option as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance

Customer Options for Additional Goods or Services

606-10-55-44

Paragraph 606-10-32-29 requires an entity to allocate the **transaction price** to performance obligations on a relative standalone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option

b. The likelihood that the option will be exercised.

606-10-55-45

If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

As stated above, if the option's standalone selling price is not directly observable, the entity will estimate it, taking into consideration the discount the customer would receive in a standalone transaction and the likelihood that the customer would exercise the option. Generally, option pricing models consider both the intrinsic value of the option (i.e., the value of the option if it were exercised today) and its time value (e.g., the option may be more or less valuable based on the amount of time until its expiration date and/or the volatility of the price of the underlying good or service). An entity is only required to measure the intrinsic value of the option under ASC 606-10-55-44 when estimating the standalone selling price of the option. In the Basis for Conclusions of ASU 2014-09,[149] the FASB noted that the benefits of requiring entities to value the time value component of an option would not justify the cost of doing so. Example 49 in the standard (included in Section 4.6) illustrates the measurement of an option determined to be a material right under ASC 606-10-55-44.

ASC 606-10-55-45 provides an alternative to estimating the standalone selling price of an option. This practical alternative applies when the goods or services are both (1) similar to the original goods and services in the contract (i.e., the entity continues to provide what it was already providing[150]) and (2) provided in accordance with the terms of the original contract. The standard indicates that this alternative generally will apply to options for contract renewals (i.e., the renewal option approach).

Under this alternative, a portion of the transaction price is allocated to the option (i.e., the material right that is a performance obligation) by reference to the total goods or services expected to be provided to the customer (including expected renewals) and the corresponding expected consideration. That is, the total amount of consideration expected to be received from the customer (including from expected renewals) is allocated to the total goods or services expected to be provided to the customer, including the expected contract renewals. The amount allocated to the goods or services that the entity is required to transfer to

[149] Paragraph BC390 of ASU 2014-09.

[150] Paragraph BC394 of ASU 2014-09.

the customer under the contract (i.e., excluding the optional goods or services that will be transferred if the customer exercises the renewal option(s)) is then subtracted from the total amount of consideration received (or that will be received) for transferring those goods or services. The difference is the amount that is allocated to the option at contract inception. An entity using this alternative would need to apply the constraint on variable consideration (as discussed in Section 5.2.3) to the estimated consideration for the optional goods or services prior to performing the allocation. See Illustration 6-1, Scenario B below.

It is important to note that the calculation of total expected consideration (i.e., the hypothetical transaction price), including consideration related to expected renewals, is only performed for purposes of allocating a portion of the hypothetical transaction price to the option at contract inception. It does not change the enforceable rights or obligations in the contract, nor does it affect the actual transaction price for the goods or services that the entity is presently obligated to transfer to the customer (which would not include expected renewals). Accordingly, the entity would not include any remaining hypothetical transaction price in its disclosure of remaining performance obligations (see Section 10.4.1). In these respects, the renewal option approach is consistent with the conclusion in Question 4-13 (see Section 4.6) that even if an entity may think that a customer almost certainly will exercise an option to buy additional goods and services, an entity should not identify the additional goods and services underlying the option as promised goods or services (or performance obligations) unless there are substantive contractual penalties.

Subsequent to contract inception, if the actual number of contract renewals differs from an entity's initial expectations, the entity would update the hypothetical transaction price and allocation accordingly. However, as discussed in Section 6.1, the estimate of the standalone selling prices at contract inception would not be updated.

The following example illustrates the two possible approaches for measuring options included in a contract:

Illustration 6-1: Measuring an option

An aftermarket home warranty provider offers a promotion to new subscribers who pay full price for the first year of coverage that would grant them an option to renew their services for up to two years at a discount. The entity regularly sells warranty coverage for $750 per year. With the promotion, the customer would be able to renew the one-year warranty at the end of the first and second years for $600. The entity concludes that the ability to renew is a material right because the customer would receive a discount that exceeds any discount available to other customers. The entity also determines that no directly observable standalone selling price exists for the option to renew at a discount.

Scenario A — Estimating the standalone selling price of the option directly (ASC 606-10-55-44)

Because the entity has no directly observable evidence of the standalone selling price for the renewal option, the entity has to estimate the standalone selling price of an option for a $150 discount on the renewal of service in years two and three. In developing its estimate, the entity would consider factors such as the likelihood that the option will be exercised and the price of comparable discounted offers. For example, the entity may consider the selling price of an offer for a discounted price of similar services found on a "deal of the day" website.

The option would then be included in the relative standalone selling price allocation. In this example, there would be two performance obligations, one year of warranty services and one option for discounted renewals. The contract consideration of $750 would be allocated between those two performance obligations based on their relative standalone selling prices.

Example 49 in the standard (included in Section 4.6) illustrates the estimation of the standalone selling price of an option determined to be a material right under ASC 606-10-55-44.

Scenario B — Practical alternative to estimating the standalone selling price of the option using the renewal option approach (ASC 606-10-55-45)

If the entity chooses to use the renewal option approach, it would allocate the transaction price to the option for warranty services by reference to the warranty services expected to be provided (including expected renewals) and the corresponding expected consideration. Since there is a discount offered on renewal of the warranty service, this calculation will result in less revenue being allocated to the first year of the warranty service than the amount of consideration received. The difference between the consideration received (or that will be received) for the first year of warranty service and the revenue allocated for the first year of warranty service will represent the amount allocated to the option using the renewal option approach.

Assume the entity obtained 100 new subscribers under the promotion. Based on its experience, the entity anticipates approximately 50% attrition annually, after also giving consideration to the anticipated effect that the $150 discount will have on attrition. The entity considers the constraint on variable consideration and concludes that it is probable that a significant revenue reversal will not occur. Therefore, the entity concludes that for this portfolio of contracts, it will ultimately sell 175 one-year warranty services (100 + 50 renewals after year one + 25 renewals after year two).

The total consideration the entity expects to receive is $120,000 [(100 x $750) + (50 x $600) + (25 x $600)] (i.e., the hypothetical transaction price). Assuming the standalone selling price for each warranty period is the same, the entity allocates $685.71 ($120,000/175) to each warranty period.

During the first year, the entity will recognize revenue of $68,571 (100 warranties sold times the allocated price of $685.71 per warranty). Consequently, at contract inception, the entity would allocate $6,429 to the option to renew ($75,000 cash received less $68,571 revenue to be recognized in the first year).

If the actual renewals in years two and three differ from its expectations, the entity would have to update the hypothetical transaction price and allocation accordingly. However, as discussed in Section 6.1, the estimate of the standalone selling prices at contract inception for the warranty service would not be updated.

For example, assume that the entity experiences less attrition than expected (e.g., 40% attrition annually instead of 50%). Therefore, the entity estimates that it will ultimately sell 196 one-year warranty services (100 + 60 renewals after year one + 36 renewals after year two). Accordingly, the total consideration the entity expects to receive is $132,600 [(100 x $750) + (60 x $600) + (36 x $600)] (i.e., the updated hypothetical transaction price). The entity would not update its estimates of the standalone selling prices (which were assumed to be the same for each warranty period). As such, the entity allocates $676.53 ($132,600/196) to each warranty period. This would require the entity to reduce the amount of revenue it recorded in year 1 by $918 ($68,571 – (100 x 676.53)) because the amount allocated to the option should have been higher at contract inception.

How we see it

The requirement to allocate contract consideration to an option (that has been determined to be a performance obligation) on a relative standalone selling price basis is consistent with legacy guidance in ASC 605-25. However, ASC 605-25 requires the entity to estimate the selling price of the option (unless other objective evidence of the selling price exists) and does not provide an alternative method (i.e., no renewal option approach) for measuring the option.

Question 6-4 **Could the form of an option (e.g., a gift card versus a coupon) affect how an option's standalone selling price is estimated?**

We believe the form of an option should not affect how the standalone selling price is estimated. Consider, for example, a retailer that gives customers who spend more than $100 during a specified period a $15 discount on a future purchase in the form of a coupon or a gift card that expires two weeks from the sale date. If the retailer determines that this type of offer represents a material right (see Section 4.6), it will need to allocate a portion of the transaction price to the option on a relative standalone selling price basis.

As discussed above, the standard requires that an entity first look to any directly observable standalone selling price. That will require the retailer to consider the nature of the underlying transaction. In this example, while a customer can purchase a $15 gift card for face value, that transaction is not the same in substance as a transaction in which the customer is given a $15 gift card or coupon in connection with purchasing another good or service. As such, we believe the retailer could conclude that there is no directly observable standalone selling price for a "free" gift card or coupon obtained in connection with the purchase of another good or service. It would then have to estimate the standalone selling price in accordance with ASC 606-10-55-44.

The estimated standalone selling price of an option given in the form of a gift card or a coupon would be the same because both estimates would reflect the likelihood that the option will be exercised (see discussion of breakage in Section 7.9).

6.2 Applying the relative standalone selling price method

Once an entity has determined the standalone selling price for the distinct goods and services in a contract, the entity allocates the transaction price to those performance obligations. The standard requires an entity to use the relative standalone selling price method to allocate the transaction price except in the two specific circumstances that are described in Sections 6.3 and 6.4.

Under the relative standalone selling price method, the transaction price is allocated to each performance obligation based on the proportion of the standalone selling price of each performance obligation to the sum of the standalone selling prices of all of the performance obligations in the contract, as described in the illustration below:

Illustration 6-2: Relative standalone selling price allocation

Manufacturing Co. enters into a contract with a customer to sell a machine for $100,000. The total contract price includes installation of the machine and a two-year extended warranty. Assume Manufacturing Co. determines there are three performance obligations, and the standalone selling prices of those performance obligations are as follows: machine — $75,000, installation services — $14,000 and extended warranty — $20,000.

The aggregate of the standalone selling prices ($109,000) exceeds the total transaction price of $100,000, indicating there is a discount inherent in the contract that must be allocated to each of the performance obligations based on their relative standalone selling prices. Therefore, the $100,000 transaction price is allocated to each performance obligation as follows:

Machine — $68,800 ($100,000 x ($75,000/$109,000))

Installation — $12,850 ($100,000 x ($14,000/$109,000))

Warranty — $18,350 ($100,000 x ($20,000/$109,000))

The entity would recognize as revenue the amount allocated to each performance obligation when (or as) each performance obligation is satisfied.

How we see it

The standard's requirements don't differ significantly from legacy requirements to allocate consideration using a relative selling price allocation. As a result, we generally do not expect the allocation of the transaction price to change significantly for entities that already perform relative selling price allocations. However, that may not be the case for entities that apply one or both of the exceptions provided in the standard (described in Sections 6.3 and 6.4). The standard also likely will require a change in practice for entities that don't apply a relative selling price allocation under legacy GAAP (e.g., entities that have applied a residual approach).

6.3 Allocating variable consideration

The relative standalone selling price method is the default method for allocating the transaction price. However, the FASB noted in the Basis for Conclusion of ASU 2014-09[151] that this method may not always result in a faithful depiction of the amount of consideration to which an entity expects to be entitled from the customer. Therefore, the standard provides two exceptions to the relative standalone selling price method to allocate the transaction price.

The first relates to the allocation of variable consideration (see Section 6.4 for the second exception). This exception allows variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations in the contract or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation (see Section 4.2.2).

Two criteria must be met to apply this exception, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocation of Variable Consideration

606-10-32-39

Variable consideration that is promised in a **contract** may be attributable to the entire contract or to a specific part of the contract, such as either of the following:

a. One or more, but not all, **performance obligations** in the contract (for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time)

b. One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

606-10-32-40

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).

[151] Paragraph BC280 of ASU 2014-09.

b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

606-10-32-41

The allocation requirements in paragraphs 606-10-32-28 through 32-38 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 606-10-32-40.

While the language in ASC 606-10-32-40 implies that this exception is limited to allocating variable consideration to a single performance obligation or a single distinct good or service within a series, ASC 606-10-32-39 indicates that the variable consideration can be allocated to "one or more, but not all" performance obligations or distinct goods or services within a series. We understand it was not the FASB's intent to limit this exception to a single performance obligation or a single distinct good or service within a series, even though the standard uses a singular construction for the remainder of the discussion and does not repeat "one or more, but not all."

The FASB noted in the Basis for Conclusions of ASU 2014-09[152] that this exception is necessary because allocating contingent amounts to all performance obligations in a contract may not reflect the economics of a transaction in all cases. Allocating variable consideration entirely to a distinct good or service may be appropriate when the amount allocated to that particular good or service is reasonable relative to all other performance obligations and payment terms in the contract. Subsequent changes in variable consideration should be allocated in a consistent manner.

Entities may need to exercise significant judgment to determine whether they meet the requirements to allocate variable consideration to specific performance obligations or distinct goods or services within a series. Entities will need to first determine whether they meet the first criterion in ASC 606-10-32-40, which requires that the terms of a variable payment specifically relate to an entity's efforts to satisfy a performance obligation or transfer a distinct good or service that is part of a series. In performing this assessment, entities will need to consider the nature of the promise identified and whether the variable payment relates to that promise. For example, an entity may conclude that the nature of the promise to provide hotel management services (including management of the hotel employees, accounting services, training, procurement) is a series of distinct services (i.e., daily hotel management). For providing this service, the entity receives a variable fee (e.g., based on a percentage of occupancy rates and reimbursement of accounting services). An entity likely will determine it meets the first criterion because the uncertainty related to the consideration is resolved on a daily basis as the entity satisfies its obligation to perform daily hotel management services. This is because the variable payments specifically relate to transferring the distinct service that is part of a series of distinct goods or services (i.e., the daily management service). The fact that the payments do not directly correlate with each of the underlying activities performed each day does not affect this assessment. Refer to Chapter 4 for further discussion of identifying the nature of the goods and services promised in a contract, including whether they meet the series criteria.

Entities will then need to determine whether they meet the second criterion in ASC 606-10-32-40 and confirm that allocating the consideration in this manner is consistent with the overall allocation objective of the standard in ASC 606-10-32-28. That is, an entity should allocate to each performance obligation (or distinct good or service promised in a series) the portion of the transaction price that reflects the amount of consideration the entity expects to be entitled in exchange for transferring those goods or services to the customer.

[152] Paragraph BC284 of ASU 2014-09.

The TRG discussed[153] four different types of contracts that may be accounted for as a series of distinct goods or services (see Section 4.2.2) and for which an entity may reasonably conclude that the allocation objective has been met (and the variable consideration could be allocated to each distinct period of service such as day, month or year) as follows:

- IT outsourcing contract in which the events that trigger the variable consideration are the same throughout the contract but the per unit price declines over the life of the contract — The allocation objective could be met if the pricing is based on market terms (e.g., if the contract contains a benchmarking clause) or the changes in price are substantive and linked to changes in an entity's cost to fulfill the obligation or value provided to the customer.
- Transaction processing contract with unknown quantity of transactions but fixed contractual rate per transaction — The allocation objective could be met if the fees are priced consistently throughout the contract, and the rates charged are consistent with the entity's standard pricing practices with similar customers.
- Hotel management contract in which monthly consideration is based on a percentage of monthly rental revenue, reimbursement of labor costs and an annual incentive payment — The allocation objective could be met for each payment stream as follows. The base monthly fees could meet the allocation objective if the consistent measure throughout the contract period (e.g., 1% of monthly rental revenue) reflects the value to the customer. The cost reimbursements could meet the allocation objective if they are commensurate with an entity's efforts to fulfill the promise each day. The annual incentive fee could also meet the allocation objective if it reflects the value delivered to the customer for the annual period and is reasonable compared with incentive fees that could be earned in other periods.
- Franchise agreement in which franchisor will receive a sales-based royalty of 5% in addition to a fixed fee — The allocation objective could be met if the consistent formula throughout the license term reasonably reflects the value to the customer of its access to the franchisor's intellectual property (e.g., reflected by the sales that access has generated for the customer).

It is important to note that allocating variable consideration to one or more, but not all, performance obligations or distinct goods or services in a series is a requirement, not a policy election. If the above criteria are met, the entity must allocate the variable consideration to the related performance obligation(s).

The standard provides the following example to illustrate when an entity may or may not be able to allocate variable consideration to a specific part of a contract (note that the example focuses on licenses of intellectual property, which are discussed in Chapter 8):

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 35 — Allocation of Variable Consideration

606-10-55-270

An entity enters into a contract with a customer for two intellectual property licenses (Licenses X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The standalone selling prices of Licenses X and Y are $800 and $1,000, respectively.

[153] 13 July 2015 TRG meeting; agenda paper no. 39.

Case A — Variable Consideration Allocated Entirely to One Performance Obligation

606-10-55-271

The price stated in the contract for License X is a fixed amount of $800, and for License Y the consideration is 3 percent of the customer's future sales of products that use License Y. For purposes of allocation, the entity estimates its sales-based royalties (that is, the variable consideration) to be $1,000, in accordance with paragraph 606-10-32-8.

606-10-55-272

To allocate the transaction price, the entity considers the criteria in paragraph 606-10-32-40 and concludes that the variable consideration (that is, the sales-based royalties) should be allocated entirely to License Y. The entity concludes that the criteria in paragraph 606-10-32-40 are met for the following reasons:

a. The variable payment relates specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y).

b. Allocating the expected royalty amounts of $1,000 entirely to License Y is consistent with the allocation objective in paragraph 606-10-32-28. This is because the entity's estimate of the amount of sales-based royalties ($1,000) approximates the standalone selling price of License Y and the fixed amount of $800 approximates the standalone selling price of License X. The entity allocates $800 to License X in accordance with paragraph 606-10-32-41. This is because, based on an assessment of the facts and circumstances relating to both licenses, allocating to License Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 606-10-32-28.

606-10-55-273

The entity transfers License Y at inception of the contract and transfers License X one month later. Upon the transfer of License Y, the entity does not recognize revenue because the consideration allocated to License Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph 606-10-55-65, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

606-10-55-274

When License X is transferred, the entity recognizes as revenue the $800 allocated to License X.

Case B — Variable Consideration Allocated on the Basis of Standalone Selling Prices

606-10-55-275

The price stated in the contract for License X is a fixed amount of $300, and for License Y the consideration is 5 percent of the customer's future sales of products that use License Y. The entity's estimate of the sales-based royalties (that is, the variable consideration) is $1,500 in accordance with paragraph 606-10-32-8.

606-10-55-276

To allocate the transaction price, the entity applies the criteria in paragraph 606-10-32-40 to determine whether to allocate the variable consideration (that is, the sales-based royalties) entirely to License Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y), allocating the variable consideration entirely to License Y would be inconsistent with the principle for allocating the transaction price. Allocating $300 to License X and $1,500 to License Y does not reflect a reasonable allocation of the transaction price on the basis of the standalone selling prices of Licenses X and Y of $800 and $1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 606-10-32-31 through 32-35.

606-10-55-277

The entity allocates the transaction price of $300 to Licenses X and Y on the basis of relative standalone selling prices of $800 and $1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative standalone selling price basis. However, in accordance with paragraph 606-10-55-65, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

606-10-55-278

License Y is transferred to the customer at the inception of the contract, and License X is transferred three months later. When License Y is transferred, the entity recognizes as revenue the $167 ($1,000 ÷ $1,800 × $300) allocated to License Y. When License X is transferred, the entity recognizes as revenue the $133 ($800 ÷ $1,800 × $300) allocated to License X.

606-10-55-279

In the first month, the royalty due from the customer's first month of sales is $200. Consequently, in accordance with paragraph 606-10-55-65, the entity recognizes as revenue the $111 ($1,000 ÷ $1,800 × $200) allocated to License Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the $89 ($800 ÷ $1,800 × $200) allocated to License X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

Question 6-5 **In order to meet the criteria to allocate variable consideration entirely to a specific part of a contract, must the resulting allocation be consistent with a relative standalone selling price allocation?**
[13 July 2015 TRG meeting; agenda paper no. 39]

No. TRG members generally agreed that a relative standalone selling price allocation is not required to meet the allocation objective when it relates to the allocation of variable consideration to a specific part of a contract (e.g., a distinct good or service in a series). The Basis for Conclusions of ASU 2014-09[154] notes that standalone selling price is the default method for meeting the allocation objective but other methods could be used in certain instances (e.g., in allocating variable consideration).

Stakeholders had questioned whether the variable consideration exception would have limited application to a series of distinct goods or services (see Section 4.2.2). That is, they wanted to know whether the guidance would require that each distinct service that is substantially the same be allocated the same amount (absolute value) of variable consideration. While the standard does not state what other allocation methods could be used beyond the relative standalone selling price basis, TRG members generally agreed that an entity should apply reasonable judgment to determine whether the allocation results in a reasonable outcome (and therefore, meets the standard's allocation objective), as discussed above in Section 6.3.

[154] Paragraph BC280 of ASU 2014-09.

6.4 Allocating a discount

The second exception to the relative standalone selling price allocation (see Section 6.3 for the first exception) relates to discounts inherent in contracts. When an entity sells a bundle of goods and services, the selling price of the bundle is often less than the sum of the standalone selling prices of the individual components. Under the relative standalone selling price method, this discount would be allocated proportionately to all of the separate performance obligations.

However, the standard says that if an entity determines that a discount is not related to all of the promised goods or services in the contract, the entity should allocate the contract's entire discount to only those goods or services to which it relates. An entity would make this determination when the price of certain goods or services is largely independent of other goods or services in the contract. In these situations, an entity would be able to effectively "carve off" an individual performance obligation, or some of the performance obligations in the contract, and allocate the contract's entire discount to that performance obligation or group of obligations. However, an entity could not use this exception to allocate only a portion of the discount to one or more, but not all, performance obligations in the contract.

The standard states the following:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocation of a Discount

606-10-32-36

A customer receives a discount for purchasing a bundle of goods or services if the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence in accordance with paragraph 606-10-32-37 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

606-10-32-37

An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.

b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.

c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

606-10-32-38

If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 606-10-32-37, an entity shall allocate the discount before using the residual approach to estimate the standalone selling price of a good or service in accordance with paragraph 606-10-32-34(c).

The FASB noted in the Basis for Conclusions of ASU 2014-09[155] that it believes the guidance in ASC 606-10-32-37 generally will apply to contracts that include at least three performance obligations. While the standard contemplates that an entity can allocate the entire discount to as few as one performance obligation, the FASB further clarified that it believes such a situation would be rare. Instead, the FASB believes it is more likely that an entity will be able to demonstrate that a discount relates to two or more performance obligations because the entity would likely have observable information that the standalone selling price of a group of promised goods or services is lower than the price of those items when sold separately. It likely would be more difficult for an entity to have sufficient evidence to demonstrate that a discount is associated with a single performance obligation.

The standard includes the following example to illustrate this exception and when the use of the residual estimation approach may or may not be appropriate:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 34 — Allocating a Discount

606-10-55-259

An entity regularly sells Products A, B, and C individually, thereby establishing the following standalone selling prices:

Product	**Standalone Selling Price**
Product A	$ 40
Product B	55
Product C	45
Total	$ 140

606-10-55-260

In addition, the entity regularly sells Products B and C together for $60.

Case A — Allocating a Discount to One or More Performance Obligations

606-10-55-261

The entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time.

606-10-55-262

The contract includes a discount of $40 on the overall transaction, which would be allocated proportionately to all 3 performance obligations when allocating the transaction price using the relative standalone selling price method (in accordance with paragraph 606-10-32-36). However, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37.

606-10-55-263

If the entity transfers control of Products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate $60 of the transaction price to the single performance obligation and recognize revenue of $60 when Products B and C simultaneously transfer to the customer.

[155] Paragraph BC283 of ASU 2014-09.

606-10-55-264

If the contract requires the entity to transfer control of Products B and C at different points in time, then the allocated amount of $60 is individually allocated to the promises to transfer Product B (standalone selling price of $55) and Product C (standalone selling price of $45) as follows:

Product	Allocated transaction price	
Product B	$ 33	($55 ÷ $100 total standalone selling price x $60)
Product C	27	($45 ÷ $100 total standalone selling price x $60)
Total	$ 60	

Case B — Residual Approach Is Appropriate

606-10-55-265

The entity enters into a contract with a customer to sell Products A, B, and C as described in Case A. The contract also includes a promise to transfer Product D. Total consideration in the contract is $130. The standalone selling price for Product D is highly variable (see paragraph 606-10-32-34(c)(1)) because the entity sells Product D to different customers for a broad range of amounts ($15 — $45). Consequently, the entity decides to estimate the standalone selling price of Product D using the residual approach.

606-10-55-266

Before estimating the standalone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 606-10-32-37 through 32-38.

606-10-55-267

As in Case A, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has observable evidence that $100 should be allocated to those 3 products and a $40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37. Using the residual approach, the entity estimates the standalone selling price of Product D to be $30 as follows:

Product	Standalone selling price	Method
Product A	$ 40	Directly observable (see paragraph 606-10-32-32)
Product B and C	60	Directly observable with discount (see paragraphs 606-10-32-37)
Product D	30	Residual approach (see paragraph 606-10-32-34(c))
Total	$ 130	

606-10-55-268

The entity observes that the resulting $30 allocated to Product D is within the range of its observable selling prices ($15 — $45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 606-10-32-28 and the guidance in paragraph 606-10-32-33.

Case C — Residual Approach Is Inappropriate

606-10-55-269

The same facts as in Case B apply to Case C except the transaction price is $105 instead of $130. Consequently, the application of the residual approach would result in a standalone selling price of $5 for Product D ($105 transaction price less $100 allocated to Products A, B, and C). The entity concludes that $5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D because $5 does not approximate the standalone selling price of Product D, which ranges from $15 — $45. Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the standalone selling price of Product D using another suitable method. The entity allocates the transaction price of $105 to Products A, B, C, and D using the relative standalone selling prices of those products in accordance with paragraphs 606-10-32-28 through 32-35.

How we see it

Allocating a discount in a multiple-element arrangement to certain, but not all, performance obligations within the contract is a significant change from legacy practice. Under legacy GAAP, discounts inherent in contracts generally are allocated across all deliverables proportionately or allocated only to the first-delivered items. While this exception will likely be helpful in certain circumstances, the criteria that must be met to demonstrate that a discount should be associated with only some of the performance obligations in the contract likely will limit the number of transactions that will be eligible for this exception.

Question 6-6

If a discount also meets the definition of variable consideration because it is variable and/or contingent on a future event, which allocation exception should an entity apply? [30 March 2015 TRG meeting; agenda paper no. 31]

TRG members generally agreed that an entity should first determine whether a variable discount meets the variable consideration exception discussed in Section 6.3. If it does not, the entity then will consider whether it meets the discount exception discussed in Section 6.4. In reaching that conclusion, the TRG agenda paper noted that ASC 606-10-32-41 establishes a hierarchy for allocating variable consideration that requires an entity to first identify variable consideration and determine whether it should allocate variable consideration to one or some, but not all, performance obligations (or distinct goods or services that comprise a single performance obligation) based on the exception for allocating variable consideration. The entity would consider the requirements for allocating a discount only if the discount is not variable consideration (i.e., the dollar amount is fixed and not contingent on future events) or the entity does not meet the criteria to allocate variable consideration to a specific part of the contract.

6.5 Changes in transaction price after contract inception

The standard provides the following guidance on accounting for changes in the transaction price after contract inception:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Changes in the Transaction Price

606-10-32-42

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

606-10-32-43

An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in standalone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

606-10-32-44

An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) only if the criteria in paragraph 606-10-32-40 on allocating variable consideration are met.

606-10-32-45

An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).

b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

As stated above, changes in the total transaction price generally are allocated to the separate performance obligations on the same basis as the initial allocation, whether they are allocated based on the relative standalone selling price (i.e., using the same proportionate share of the total) or to individual performance obligations under the variable consideration exception discussed in Section 6.3. As discussed in Section 6.1, standalone selling prices are not updated after contract inception, unless the contract has been modified.

If the change in the transaction price is due to a contract modification, the contract modification guidance in ASC 606-10-25-10 through 25-13 must be followed (see Section 3.4 for a discussion of contract modifications).

However, when contracts include variable consideration, it is possible that changes in the transaction price can arise after a modification, and such changes may or may not be related to performance obligations that existed before the modification. For changes in the transaction price arising after a contract modification that was not treated as a separate contract, an entity must apply one of the two approaches included in ASC 606-10-32-45 above.

6.6 Allocation of transaction price to elements outside the scope of the standard

Revenue arrangements frequently contain multiple elements, including some elements that are not in the scope of the revenue literature. As discussed further in Section 2.4, the standard indicates that in such situations, an entity must first apply the other guidance if that guidance addresses separation and/or measurement.

For example, other guidance requires certain items, such as derivatives within the scope of ASC 815 and guarantees within the scope of ASC 460, to be accounted for at fair value. As a result, when a revenue arrangement includes that type of element, the fair value of that element must be separated from the total transaction price, and the remaining transaction price should be allocated to the remaining performance obligations.

The following example illustrates this concept:

Illustration 6-3: Arrangements with elements outside the scope of the standard

Company A, an auto manufacturer, sells vehicles to Company B, a fleet customer, under contracts that include guaranteed auction values (i.e., a guaranteed minimum resale value). Company B takes title to each vehicle at the time of sale, and title remains with Company B until resale to a third party. Upon resale by Company B, to the extent the resale price is below the guaranteed minimum resale value, Company A agrees to pay Company B the difference between the resale proceeds received and the guaranteed minimum resale value. The guaranteed minimum resale value is agreed to at the inception of the contract and is a fixed amount. The contract does not include a repurchase agreement (see Section 7.3) under the standard (i.e., title does not revert back to the manufacturer at any time).

Company A sells a vehicle to Company B for total consideration of $50,000. The standalone selling price of the vehicle and the fair value of the guarantee are $48,000 and $4,000, respectively.

Analysis

The contract with a guaranteed minimum resale value contains a guarantee within the scope of ASC 460 (see further discussion in Section 7.3.3). In accordance with ASC 606-10-15-4, because ASC 460 provides measurement guidance (i.e., requires that guarantees in its scope be initially recorded at fair value), Company A will exclude from the transaction price the guarantee's fair value and allocate the remaining transaction price to the vehicle. The allocation of the total transaction price is as follows:

	Selling price and fair value	% Allocated discount	Allocated discount	Arrangement consideration allocation
Vehicle	$ 48,000	100%	$ 2,000	$ 46,000
Guarantee	4,000	0%	–	4,000
	$ 52,000		$ 2,000	$ 50,000

For elements that must be accounted for at fair value at inception, any remeasurement (i.e., the "day two" accounting) should be pursuant to other GAAP (e.g., ASC 815 on derivatives, ASC 460 on guarantees). That is, subsequent adjustments to the fair value of those elements have no effect on the amount of the transaction price previously allocated to any performance obligations included in the arrangement or on revenue recognized.

7 Satisfaction of performance obligations

Under the standard, an entity recognizes revenue only when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Recognizing revenue upon a transfer of control is a different approach from the "risks and rewards" model in legacy GAAP. The standard defines control as an entity's ability to direct the use of and obtain substantially all of the remaining benefits of an asset. The Board noted[156] that both goods and services are assets that a customer acquires (even if many services are not recognized as an asset because those services are simultaneously received and consumed by the customer). The FASB explained the key terms in the definition of control in the Basis for Conclusions of ASU 2014-09[157] as follows:

- **Ability** — A customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognize revenue. For example, in a contract that requires a manufacturer to produce an asset for a customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, the entity should not recognize revenue until the customer has actually obtained that right (which, depending on the contract, might occur during production or afterwards).
- **Direct the use of** — A customer's ability to direct the use of an asset refers to the customer's right to deploy or to allow another entity to deploy that asset in its activities or to restrict another entity from deploying that asset.
- **Obtain the benefits from** — The customer must have the ability to obtain substantially all of the remaining benefits from an asset for the customer to obtain control of it. Conceptually, the benefits from a good or service are potential cash flows (either an increase in cash inflows or a decrease in cash outflows). A customer can obtain the benefits directly or indirectly in many ways, such as by using, consuming, disposing of, selling, exchanging, pledging or holding an asset.

The transfer of control to the customer represents the transfer of the rights with regard to the good or service. The customer's ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services. Upon transfer of control, the customer has sole possession of the right to use the good or service for the remainder of its economic life or to consume the good or service in its own operations.

The FASB explained in the Basis for Conclusions of ASU 2014-09[158] that control should be assessed primarily from the customer's perspective. While a seller often surrenders control at the same time the customer obtains control, the Board required the assessment of control to be from the customer's perspective to minimize the risk of an entity recognizing revenue from activities that do not coincide with the transfer of goods or services to the customer.

The standard states that an entity must determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. These concepts are explored further in the following sections.

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[156] Paragraph BC118 of ASU 2014-09.
[157] Paragraph BC120 of ASU 2014-09.
[158] Paragraph BC121 of ASU 2014-09.

The standard provides the following overall guidance on satisfaction of performance obligations:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Satisfaction of Performance Obligations

606-10-25-23

An entity shall recognize revenue **when (or as) the entity satisfies a** performance obligation **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 of that asset.**

606-10-25-24

For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

606-10-25-25

Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

a. Using the asset to produce goods or provide services (including public services)

b. Using the asset to enhance the value of other assets

c. Using the asset to settle liabilities or reduce expenses

d. Selling or exchanging the asset

e. Pledging the asset to secure a loan

f. Holding the asset.

7.1 Performance obligations satisfied over time

Frequently, entities transfer promised goods and services to a customer over time. While the determination of whether goods or services are transferred over time is straightforward in some contracts (e.g., many service contracts), this determination is more difficult in other contracts. To help entities determine whether control transfers over time (rather than at a point in time), the FASB provided the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

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).

Examples of each of the above criteria are included in the following sections. If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time (see Section 7.2).

How we see it

For each performance obligation identified in the contract, an entity is required to consider at contract inception whether it satisfies the performance obligation over time (i.e., whether it meets one of the three criteria for over time recognition) or at a point in time. This evaluation will require many entities to perform new analyses or analyses that differ from what they do under legacy GAAP. For example, an entity with construction contracts is no longer required to evaluate whether the transactions are in the scope of legacy industry-specific guidance (i.e., ASC 605-35) but instead needs to determine whether its performance obligations are satisfied over time by evaluating the three criteria for over time recognition. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

7.1.1 Customer simultaneously receives and consumes benefits as the entity performs

As the Board explained in the Basis for Conclusions of ASU 2014-09,[159] the entity's performance in many service contracts creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In these cases, the customer obtains control of the entity's output as it performs and, thus, the performance obligation is satisfied over time. Because there may be service contracts in which it is unclear whether the customer simultaneously receives and consumes the benefit of the entity's performance over time, the Board included the following implementation guidance in the standard:

[159] Paragraph BC125 of ASU 2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Simultaneous Receipt and Consumption of the Benefits of the Entity's Performance (paragraph 606-10-25-27(a))

606-10-55-5

For some types of **performance obligations**, the assessment of whether a **customer** receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

606-10-55-6

For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer. In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity should make both of the following assumptions:

a. Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity

b. Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

The Board added this implementation guidance because the notion of "benefit" can be subjective. In the Basis for Conclusions of ASU 2014-09,[160] the Board provided an example of a freight logistics contract in which the entity has agreed to transport goods from Vancouver to New York City. Some stakeholders suggested that the customer receives no benefit from the entity's performance until the goods are delivered to New York City. However, the Board said the customer benefits as the entity performs because if the goods were only delivered part way (e.g., to Chicago), another entity would not need to substantially reperform the entity's performance to date. The Board observed that in these cases, the assessment of whether another entity would need to substantially reperform the entity's performance to date is an objective way to assess whether the customer receives benefit from the entity's performance as it occurs.

In assessing whether a customer simultaneously receives and consumes the benefits provided by an entity's performance, all relevant facts and circumstances should be considered, including the inherent characteristics of the good or service, the contract terms and information about how the good or service is transferred or delivered. However, as noted in ASC 606-10-55-6a, the Board decided that an entity should disregard any contractual or practical restrictions when it assesses this criterion. In the Basis for Conclusions of ASU 2014-09,[161] the FASB explained that the assessment of whether control of the goods or services has transferred to the customer should be performed by making a hypothetical assessment of

[160] Paragraph BC126 of ASU 2014-09.

[161] Paragraph BC127 of ASU 2014-09.

what another entity would need to do if it were to take over the remaining performance. Therefore, actual practical or contractual restrictions would have no bearing on the assessment of whether the entity had already transferred control of the goods or services provided to date.

The standard provides the following example showing a customer simultaneously receiving and consuming the benefits as the entity performs a series of distinct payroll processing services:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 13 — Customer Simultaneously Receives and Consumes the Benefits

606-10-55-159

An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

606-10-55-160

The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 606-10-25-14(b). The performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to reperform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

The FASB clarified in the Basis for Conclusions of ASU 2014-09[162] that an entity does not evaluate this criterion to determine whether a performance obligation is satisfied over time if the entity's performance creates an asset the customer does not consume immediately as the asset is received. Instead, an entity assesses that performance obligation using the criteria discussed in Sections 7.1.2 and 7.1.3.

For some service contracts, an entity will not satisfy its obligation over time because the customer does not consume the benefit of the entity's performance until the entity's performance is complete. Example 14 in the standard (excerpted in full in Section 7.1.3) depicts an entity providing consulting services that will take the form of a professional opinion upon the completion of the services. In this situation, an entity cannot conclude that the services are transferred over time based on this criterion. Instead, it must consider the other two criteria (see Sections 7.1.2 and 7.1.3 and Example 14 below).

7.1.2 Customer controls asset as it is created or enhanced

The second criterion for determining whether control of a good or service is transferred over time requires entities to evaluate whether the customer controls the asset as it is being created or enhanced. This criterion is described in the standard as follows:

[162] Paragraph BC128 of ASU 2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Customer Controls the Asset As It Is Created or Enhanced (paragraph 606-10-25-27(b))

606-10-55-7

In determining whether a customer controls an asset as it is created or enhanced in accordance with paragraph 606-10-25-27(b), an entity should apply the guidance on control in paragraphs 606-10-25-23 through 25-26 and 606-10-25-30. The asset that is being created or enhanced (for example, a work in process asset) could be either tangible or intangible.

For purposes of this determination, the definition of "control" is the same as previously discussed (i.e., the ability to direct the use of and obtain substantially all of the remaining benefits from the asset). The FASB explained in the Basis for Conclusions of ASU 2014-09[163] that this criterion addresses situations in which the customer controls any work in progress arising from the entity's performance. For example, many construction contracts with the US federal government contain clauses indicating that the government owns any work-in-progress as the contracted item is being built and, as a result, the performance obligation would be satisfied over time. Further, the asset being created or enhanced can be intangible.

How we see it

The Board observed in the Basis for Conclusions of ASU 2014-09[164] that the second over-time criterion (related to the customer's control of the asset as it is being created or enhanced) is consistent with the rationale for the percentage-of-completion revenue recognition approach for construction contracts under ASC 605-35. Both approaches acknowledge that, in effect, the entity has agreed to sell its rights to the asset (i.e., work in progress) as the entity performs (i.e., a continuous sale).

7.1.3 Asset with no alternative use and right to payment

In some cases, it may be unclear whether the asset that an entity creates or enhances is controlled by the customer when considering the first two criteria for evaluating whether control transfers over time. Therefore, the Board added a third criterion, which requires revenue to be recognized over time if both of the following requirements are met:

- The entity's performance does not create an asset with an alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

Each of these concepts is discussed further below.

Alternative use

The FASB said in the Basis for Conclusions of ASU 2014-09[165] that it developed the notion of "alternative use" to prevent over time revenue recognition when the entity's performance does not transfer control of the goods or services to the customer over time. When the entity's performance creates an asset with an alternative use to the entity (e.g., standard inventory items), the entity can

[163] Paragraph BC129 of ASU 2014-09.

[164] Paragraph BC130 of ASU 2014-09.

[165] Paragraph BC134 of ASU 2014-09.

readily direct the asset to another customer. In those cases, the entity (not the customer) controls the asset as it is created because the customer does not have the ability to direct the use of the asset or restrict the entity from directing that asset to another customer. The standard includes the following guidance on alternative use:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied Over Time

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 to 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.

Implementation Guidance and Illustrations

Entity's Performance Does Not Create an Asset with an Alternative Use (paragraph 606-10-25-27(c))

606-10-55-8

In assessing whether an asset has an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different **customer**. The possibility of the **contract** with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

606-10-55-9

A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

606-10-55-10

A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

In making the assessment of whether a good or service has an alternative use, an entity must consider any substantive contractual restrictions. A contractual restriction is substantive if an entity expects the customer to enforce its rights to the promised asset if the entity sought to direct the asset for another use.

Contractual restrictions that are not substantive, such as protective rights for the customer, should not be considered. The Board explained in the Basis for Conclusions of ASU 2014-09[166] that a protective right typically gives an entity the practical ability to physically substitute or redirect the asset without the customer's knowledge or objection to the change. For example, a contract that states an entity cannot transfer a good to another customer because the customer has legal title to the good would not be substantive if the entity could physically substitute another good and redirect the original good to another customer for little cost. In this case, the contractual restriction is merely a protective right, and the entity concludes that control of the asset has not transferred to the customer.

An entity also will need to consider any practical limitations on directing the asset for another use. In making this determination, the Board clarified in the Basis for Conclusions of ASU 2014-09[167] that an entity should consider the characteristics of the asset that ultimately will be transferred to the customer and assess whether the asset in its completed state could be redirected without a significant cost of rework. The Board provided an example of manufacturing contracts in which the basic design of the asset is the same across all contracts but substantial customization is made to the asset. As a result, redirecting the finished asset would require significant rework, and the asset would not have an alternative use because the entity would incur significant economic losses to direct the asset for another use.

Considering the level of customization of an asset may help entities assess whether an asset has an alternative use. The FASB noted in the Basis for Conclusions of ASU 2014-09[168] that when an entity is creating an asset that is highly customized for a particular customer, it is less likely that the entity could use that asset for any other purpose. That is, the entity would likely need to incur significant rework costs to redirect the asset to another customer or sell the asset at a significantly reduced price. As a result, the asset would not have an alternative use to the entity, and the customer could be regarded as receiving the benefit of the entity's performance as the entity performs (i.e., having control of the asset) provided that the entity also has an enforceable right to payment (discussed below). However, the Board clarified[169] that the level of customization is a factor to consider, but it should not be a determinative factor. For example, in some real estate contracts, the asset may be standardized (i.e., not highly customized) but still may not have an alternative use to the entity because of substantive contractual restrictions that preclude the entity from readily directing the asset to another customer.

The standard provides the following example to illustrate an evaluation of practical limitations on directing an asset for another use:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 15 — Asset Has No Alternative Use to the Entity

606-10-55-165

An entity enters into a contract with a customer, a government agency, to build a specialized satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

[166] Paragraph BC138 of ASU 2014-09.
[167] Paragraph BC136 of ASU 2014-09.
[168] Paragraph BC135 of ASU 2014-09.
[169] Paragraph BC137 of ASU 2014-09.

606-10-55-166

At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

606-10-55-167

As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 606-10-25-27(c), 606-10-25-28, and 606-10-55-8 through 55-10) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

606-10-55-168

For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 606-10-25-27(c) also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this Example.

Requiring an entity to assess contractual restrictions when evaluating this criterion may seem to contradict the requirements in ASC 606-10-55-6 to ignore contractual and practical restrictions when evaluating whether another entity would need to substantially reperform the work the entity has completed to date (see Section 7.1.1). The Board explained[170] that this difference is appropriate because each criterion provides a different method for assessing when control transfers, and the criteria were designed to apply to different situations.

After contract inception, an entity does not update its assessment of whether an asset has an alternative use for any subsequent changes in facts and circumstances, unless the parties approve a contract modification that substantively changes the performance obligation. The FASB also decided[171] that an entity's lack of an alternative use for an asset does not, by itself, mean that the customer effectively controls the asset. The entity would also need to determine that it has an enforceable right to payment for performance to date, as discussed below.

Enforceable right to payment for performance completed to date

To evaluate whether it has an enforceable right to payment for performance completed to date, the entity is required to consider the terms of the contract and any laws or regulations that relate to it. The standard states that the right to payment for performance completed to date need not be for a fixed amount. However, at any time during the contract term, an 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. The FASB concluded[172] that a customer's obligation to pay for the entity's performance is an indicator that the customer has obtained benefit from the entity's performance.

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[170] Paragraph BC139 of ASU 2014-09.
[171] Paragraph BC141 of ASU 2014-09.
[172] Paragraph BC142 of ASU 2014-09.

The standard says the following about an entity's right to payment for performance completed to date:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied Over Time

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 and Illustrations

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.

606-10-55-12

An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

606-10-55-13

In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

606-10-55-14

In assessing the existence and enforceability of a right to payment for performance completed to date, an entity should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

a. Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.

b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.

c. An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

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.

The FASB described in the Basis for Conclusions of ASU 2014-09[173] how the factors of "no alternative use" and the "right to payment" relate to the assessment of control. Because an entity is constructing an asset with no alternative use to the entity, the entity is effectively creating an asset at the direction of the customer. That asset would have little or no value to the entity if the customer terminated the contract. As a result, the entity will seek economic protection from the risk of customer termination by requiring the customer to pay for the entity's performance to date upon customer termination. The customer's obligation to pay for the entity's performance to date (or, the inability to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance.

The enforceable right to payment criterion has two components that an entity must assess: (1) what *amount* would the customer be required to pay and (2) what does it mean to have the *enforceable right* to payment. The Board provided additional guidance on how to evaluate each of these components.

First, the Board explained in the Basis for Conclusions of ASU 2014-09[174] that the focus of the analysis should be on the amount to which the entity would be entitled upon termination. This amount is not the amount the entity would settle for in a negotiation, and it does not need to reflect the full contract margin

[173] Paragraph BC142 of ASU 2014-09.

[174] Paragraph BC144 of ASU 2014-09.

the entity would earn if the contract were completed. The Board clarified in ASC 606-10-55-11 that a "reasonable profit margin" would either be a proportion of the entity's expected profit margin that reasonably reflects the entity's performance to date or a reasonable return on the entity's cost of capital. In addition, the standard clarifies in ASC 606-10-55-15 that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. The entity must examine information that may contradict the payment schedule and may represent the entity's actual right to payment for performance completed to date. As highlighted in Example 16 below, payments from a customer must approximate the selling price of the goods or services transferred to date to be considered a right to payment for performance to date. A fixed payment schedule may not meet this requirement.

Second, the Board added guidance in ASC 606-10-55-14 to help an entity determine whether the right to payment is enforceable. Entities are required to consider any laws, legislation or legal precedent that could supplement or override the contractual terms. This may require entities to consult with legal counsel to establish their enforceable right to payment for performance completed to date. Further, the standard states that an entity can have an enforceable right to payment even when the customer does not have the right to terminate if the contract (or other laws) entitles the entity to continue to transfer the goods or services promised in the contract and require the customer to pay the consideration promised for those goods or services (often referred to as specific performance). The standard also states that even when an entity chooses to waive its right to payment in other similar contracts, an entity would continue to have a right to payment for the contract if, in the contract, its right to payment for performance to date remains enforceable.

The standard provides the following examples to illustrate the concepts described in Section 7.1.3. Example 14 depicts an entity providing consulting services that will take the form of a professional opinion upon the completion of the services as follows. In this example, the entity's performance obligation meets the no alternative use and right to payment criterion of ASC 606-10-25-27(c) as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 14 — Assessing Alternative Use and Right to Payment

606-10-55-161

An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 percent margin. The 15 percent margin approximates the profit margin that the entity earns from similar contracts.

606-10-55-162

The entity considers the criterion in paragraph 606-10-25-27(a) and the guidance in paragraphs 606-10-55-5 through 55-6 to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially reperform the work that the entity had completed to date because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 606-10-25-27(a) is not met.

606-10-55-163

However, the entity's performance obligation meets the criterion in paragraph 606-10-25-27(c) and is a performance obligation satisfied over time because of both of the following factors:

a. In accordance with paragraphs 606-10-25-28 and 606-10-55-8 through 55-10, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.

b. In accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

606-10-55-164

Consequently, the entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

Example 16 illustrates a contract in which the fixed payment schedule is not expected to correspond, at all times throughout the contract, to the amount that would be necessary to compensate the entity for performance completed to date. Accordingly, the entity concludes that it does not have an enforceable right to payment for performance completed to date as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 16 — Enforceable Right to Payment for Performance Completed to Date

606-10-55-169

An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 percent of the contract price, regular payments throughout the construction period (amounting to 50 percent of the contract price), and a final payment of 40 percent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are nonrefundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

606-10-55-170

At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

606-10-55-171

As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 606-10-25-27(c), 606-10-25-29, and 606-10-55-11 through 55-15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are nonrefundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

606-10-55-172

Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 606-10-25-27(c). Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 606-10-25-27(a) or (b), and, thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Example 17 contrasts similar situations and illustrates when revenue would be recognized over time (see Section 7.1) versus at a point in time (see Section 7.2). Specifically, this example illustrates the evaluation of the no alternative use and right to payment for performance to date concepts as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 17 — Assessing Whether a Performance Obligation Is Satisfied at a Point in Time or Over Time

606-10-55-173

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A — Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date

606-10-55-174

The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

606-10-55-175

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 606-10-25-27(c). Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Case B — Entity Has an Enforceable Right to Payment for Performance Completed to Date

606-10-55-176

The customer pays a nonrefundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

606-10-55-177

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

606-10-55-178

The entity also has a right to payment for performance completed to date in accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

606-10-55-179

Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 606-10-25-27(c) are met, and the entity has a performance obligation that it satisfies over time. To recognize revenue for that performance obligation satisfied over time, the entity measures its progress toward complete satisfaction of its performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

606-10-55-180

In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract.

Case C — Entity Has an Enforceable Right to Payment for Performance Completed to Date

606-10-55-181

The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

606-10-55-182

Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph 606-10-55-13), provided that the entity's rights to require the customer to continue to perform as required under the contract (that is, pay the promised consideration) are enforceable.

Question 7-1 **In order to have an enforceable right to payment for performance completed to date, does an entity need to have a present unconditional right to payment?**

No. In the Basis for Conclusions of ASU 2014-09,[175] the Board clarified that the contractual payment terms in a contract may not always align with an entity's enforceable rights to payment for performance completed to date. As a result, an entity does not need to have a present unconditional right to payment; instead, it must have an enforceable right to demand and/or retain payment for performance completed to date upon customer termination without cause. To illustrate this point, the Board included an example of a consulting contract that requires an entity to provide a report at the end of the project for a fixed amount due to the entity when it delivers the report. Assuming that the entity was performing under the contract and the contract or the law requires the customer to compensate the entity for its performance completed to date, the entity would have an enforceable right to payment for performance completed to date even though an unconditional right to the fixed amount only exists at the time the report is provided to the customer. This is because the entity has a right to demand and retain payment for performance completed to date.

Question 7-2 **Does an entity have a right to payment for performance completed to date if the entity receives a nonrefundable up-front payment that represents the full transaction price?**

Yes. The Board explained in the Basis for Conclusions of ASU 2014-09[176] that, because a full up-front payment would at least compensate an entity for work completed to date throughout the contract, such a payment would represent an entity's right to payment for performance completed to date provided that the entity's right to retain and not refund the payment is enforceable upon termination by the customer.

7.1.4 Measuring progress

When an entity has determined that a performance obligation is satisfied over time, the standard requires the entity to select a single revenue recognition method for the relevant performance obligation that faithfully depicts the entity's performance in transferring control of the goods or services. The standard provides the following guidance to meet this objective:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Measuring Progress toward Complete Satisfaction of a Performance Obligation

606-10-25-31

For each **performance obligation** satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, 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).

606-10-25-32

An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

[175] Paragraph BC145 of ASU 2014-09.

[176] Paragraph BC146 of ASU 2014-09.

Methods for Measuring Progress

606-10-25-33

Appropriate methods of measuring progress include output methods and input methods. Paragraphs 606-10-55-16 through 55-21 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.

606-10-25-34

When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

606-10-25-35

As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

Reasonable Measures of Progress

606-10-25-36

An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

606-10-25-37

In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

While the standard requires an entity to update its estimates related to the measure of progress selected, it does not allow a change in methods. That is, a performance obligation is accounted for under the method the entity selects (i.e., either the specific input or output method it has chosen) until the performance obligation has been fully satisfied. It would not be appropriate for an entity to start recognizing revenue based on an input measure, and then switch to an output measure (or to switch from one input method to a different input method). Further, the standard requires that the selected method be applied to similar contracts in similar circumstances and that a single method of measuring progress be used for each performance obligation. The Board noted[177] that applying more than one method to measure performance would effectively override the guidance on identifying performance obligations.

[177] Paragraph BC161 of ASU 2014-09.

If an entity does not have a reasonable basis to measure its progress, revenue should not be recognized until progress can be measured. An entity may be able to determine that a loss will not be incurred but may be unable to reasonably estimate the amount of profit. Until an entity is able to reasonably measure the outcome, the standard requires the entity to recognize revenue only up to the amount of the costs incurred. However, the FASB explained[178] that an entity should stop using this method once it is able to reasonably measure its progress toward satisfaction of the performance obligation. Finally, stakeholders had asked whether an entity's inability to measure progress would mean that costs also would be deferred. The Board clarified[179] that costs cannot be deferred in these situations unless they meet the criteria for capitalization under ASC 340-40-25-5 (see Section 9.3.2).

The standard provides two types of methods for recognizing revenue on contracts involving the transfer of goods and services over time — (1) input methods and (2) output methods. The standard says the following about those methods:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

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.

[178] Paragraph BC180 of ASU 2014-09.
[179] Paragraph BC179 of ASU 2014-09.

606-10-55-18

As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

606-10-55-19

The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.

Input Methods

606-10-55-20

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.

In determining the method of measuring progress that faithfully depicts an entity's performance, the entity has to consider both the nature of the promised goods or services and the nature of the entity's performance. In other words, an entity's selection of the method used to measure its performance needs to be consistent with the nature of its promise to the customer and what the entity has agreed to transfer to the customer. To illustrate this concept, the Board included an example of a contract for health club services in the Basis for Conclusions of ASU 2014-09.[180] Regardless of when or how frequently the customer uses the health club, the entity's obligation to stand ready for the contracted period of time does not change, and the customer is required to pay the fee regardless of whether the customer uses the health club. As a result, the entity would need to select a measure of progress based on its service of standing ready to make the health club available.

7.1.4.1 Output methods

While there is no preferable measure of progress, the FASB states in the Basis for Conclusions of ASU 2014-09[181] that conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods and services transferred to the customer. However, the Board discussed[182] two output methods, units of delivery and units of production, that may not always be appropriate.

[180] Paragraph BC160 of ASU 2014-09.
[181] Paragraph BC164 of ASU 2014-09.
[182] Paragraph BC165 of ASU 2014-09.

That is, units-of-delivery or units-of-production methods may not result in the best depiction of an entity's performance over time if there is material work-in-process at the reporting period end. In these cases, the FASB observed that using a units-of-delivery or units-of-production method would distort the entity's performance because it would not recognize revenue for the customer-controlled assets that are created before delivery or before construction is complete. This is because, when an entity determines control transfers to the customer over time, it has concluded that the customer controls any resulting asset as it is created. Therefore, the entity must recognize revenue related to those goods or services for which control has transferred. The FASB also stated in the Basis for Conclusions of ASU 2014-09[183] that a units-of-delivery or units-of-production method also may not be appropriate if the contract provides both design and production services because each item produced "may not transfer an equal amount of value to the customer." That is, the items produced earlier likely have a higher value than the ones produced later.

It is important to note that "value to the customer" in paragraph ASC 606-10-55-17 refers to an objective method of measuring the entity's performance in the contract (and is not intended to be assessed by reference to the market prices, standalone selling prices or the value a customer perceives to be embodied in the goods or services).[184] The FASB staff clarified in a TRG agenda paper[185] that this concept of value is different from the concept of value an entity uses to determine whether it can use the "right to invoice" practical expedient, as discussed below. When an entity determines whether items individually transfer an equal amount of value to the customer (i.e., when applying ASC 606-10-55-17), the FASB staff emphasized that the evaluation has to do with how much or what proportion of the goods or services (i.e., quantities) have been delivered (but not the price). For example, for purposes of applying ASC 606-10-55-17, an entity might consider the amount of goods or services transferred to date in proportion to the total expected goods or services to be transferred when measuring progress. However, if this measure of progress results in material work-in-progress at the reporting period end, it would not be appropriate, as discussed above. See the discussion below regarding the evaluation of "value to the customer" in the context of evaluating the "right to invoice" practical expedient in ASC 606-10-55-18.

Practical expedient for measuring progress toward satisfaction of a performance obligation

The FASB provided a practical expedient in ASC 606-10-55-18 for using an output method to measure progress toward completion of a performance obligation that is satisfied over time. If an entity demonstrates that the invoiced amount corresponds directly with the value to the customer of the entity's performance completed to date, the practical expedient allows an entity to recognize revenue in the amount for which it has the right to invoice (i.e., the "right to invoice" practical expedient). An entity might be able to use this practical expedient for a service contract in which it bills a fixed amount for each hour of service provided.

The FASB staff noted in a TRG agenda paper[186] that ASC 606-10-55-18 is intended as an expedient to some aspects of Steps 3, 4 and 5 in the standard. Because this practical expedient allows an entity to recognize revenue on the basis of invoicing, revenue is recognized by multiplying the price assigned to the goods or services delivered by the measure of progress (i.e., the quantities or units transferred). Therefore, an entity effectively bypasses the steps of determining the transaction price, allocating that transaction price to the performance obligations and determining when to recognize revenue. However, it does not permit an entity to bypass the requirements to determine the performance obligations in the contract and evaluate whether the performance obligation is satisfied over time, which is a requirement to use this expedient.

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[183] Paragraph BC166 of ASU 2014-09.

[184] Paragraph BC163 of ASU 2014-09.

[185] 13 July 2015 TRG meeting; agenda paper no. 40.

[186] 13 July 2015 TRG meeting; agenda paper no. 40.

To apply the practical expedient, an entity must also be able to assert that the right to consideration from a customer corresponds directly with the value to the customer of the entity's performance to date. In determining whether the amount invoiced to the customer corresponds directly with the value to the customer of an entity's performance completed to date, the entity could evaluate the amount invoiced in comparison to market prices, standalone selling prices or another reasonable measure of value to the customer. See Question 7-7 in Section 7.1.4.3 for the TRG discussion on evaluating value to the customer in contracts with changing rates.

Further, TRG members also noted in their discussion of the TRG agenda paper[187] that an entity would have to evaluate all significant up-front payments or retroactive adjustments (e.g., accumulating rebates) to determine whether the amount the entity has a right to invoice for each good or service corresponds directly to the value to the customer of the entity's performance completed to date. That is, if an up-front payment or retroactive adjustment significantly shifts payment to the front- or back-end of a contract, it may be difficult for an entity to conclude that the amount invoiced corresponds directly with the value provided to the customer for goods or services.

The TRG agenda paper also stated that the presence of an agreed-upon customer payment schedule does not mean that the amount an entity has the right to invoice corresponds directly with the value to the customer of the entity's performance completed to date. In addition, the TRG agenda paper stated that the existence of specified contract minimums (or volume discounts) would not always preclude the application of the practical expedient, provided that these clauses are deemed non-substantive (e.g., the entity expects to receive amounts in excess of the specified minimums).

7.1.4.2 Input methods

Input methods recognize revenue based on an entity's efforts or inputs toward satisfying a performance obligation relative to the total expected efforts or inputs to satisfy the performance obligation. Examples of input methods mentioned in the standard include costs incurred, time elapsed, resources consumed or labor hours expended. An entity should select a single measure of progress for each performance obligation that depicts the entity's performance in transferring control of goods or services promised to a customer. If an entity's efforts or inputs are used evenly throughout the entity's performance period, a time-based measure that results in a straight line recognition of revenue may be appropriate. However, there may be a disconnect between an entity's inputs (e.g., cost of non-distinct goods included in a single performance obligation satisfied over time) and the depiction of an entity's performance to date. The standard includes specific guidance on adjustments to the measure of progress that may be necessary in those situations. See below for additional discussion.

Regardless of which method an entity selects, it excludes from its measure of progress any goods or services for which control has not transferred to the customer.

Adjustments to the measure of progress when based on an input method

If an entity applies an input method that uses costs incurred to measure its progress toward completion (e.g., cost to cost), the cost incurred may not always be proportionate to the entity's progress in satisfying the performance obligation. To address this shortcoming of input methods, the standard provides the following guidance:

[187] 13 July 2015 TRG meeting; agenda paper no. 40.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Methods for Measuring Progress toward Complete Satisfaction of a Performance Obligation

Input Methods

606-10-55-21

A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a **customer**. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).

b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

    1. The good is not distinct.
    2. The customer is expected to obtain control of the good significantly before receiving services related to the good.
    3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
    4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

In a combined performance obligation composed of non-distinct goods and services, the customer may obtain control of the some of the goods before the entity provides the services related to those goods. This could be the case when goods are delivered to a customer site, but the entity has not yet integrated the goods into the overall project (e.g., the materials are "uninstalled"). The FASB concluded[188] that using a measure of progress based on costs incurred for such a transaction may be inappropriately affected by the delivery of these goods and that a pure application of such a measure of progress would overstate revenue.

[188] Paragraph BC171 of ASU 2014-09.

The standard indicates that, in these situations (e.g., when control of the individual goods has transferred to the customer but the integration service has not yet occurred), the best depiction of the entity's performance may be to recognize revenue at an amount equal to the cost of the goods used to satisfy the performance obligation (i.e., a zero margin) because the cost incurred is not proportionate to an entity's progress in satisfying the performance obligation. The standard specifies in ASC 606-10-55-21 that it may be more appropriate to recognize revenue only to the extent of costs incurred in these situations. It is also important to note that determining when control of the individual goods that are part of a performance obligation has transferred to the customer will require judgment.

The Board noted[189] that the adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of construction-type goods that have a significant cost relative to the contract and for which the entity is effectively providing a simple procurement service to the customer. By applying the adjustment to recognize revenue at an amount equal to the cost of uninstalled materials, an entity is recognizing a margin similar to the one the entity would have recognized if the customer had supplied the materials. The FASB clarified[190] that this outcome of recognizing no margin for uninstalled materials is necessary to adjust the cost-to-cost calculation to faithfully depict an entity's performance.

In addition, situations may arise in which not all of the costs incurred contribute to the entity's progress in completing the performance obligation. ASC 606-10-55-21(a) requires that, under an input method, an entity would exclude these types of costs (e.g., costs related to significant inefficiencies, wasted materials, required re-work) from the measure of progress unless such costs were reflected in the price of the contract.

The standard includes the following example illustrating how uninstalled materials are considered in measuring progress toward complete satisfaction of a performance obligation:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 19 — Uninstalled Materials

606-10-55-187

In November 20X2, an entity contracts with a customer to refurbish a 3-story building and install new elevators for total consideration of $5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are $4 million, including $1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs 606-10-55-36 through 55-40 because it obtains control of the elevators before they are transferred to the customer.

606-10-55-188

A summary of the transaction price and expected costs is as follows:

Transaction price	$ 5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	2,500,000
Total expected costs	$ 4,000,000

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[189] Paragraph BC172 of ASU 2014-09.

[190] Paragraph BC174 of ASU 2014-09.

606-10-55-189

The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation in accordance with paragraph 606-10-55-21. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators ($1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation ($4 million). The entity is not involved in designing or manufacturing the elevators.

606-10-55-190

The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph 606-10-55-21, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

606-10-55-191

As of December 31, 20X2, the entity observes that:

a. Other costs incurred (excluding elevators) are $500,000.

b. Performance is 20% complete (that is, $500,000 ÷ $2,500,000).

606-10-55-192

Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	$ 2,200,000[(a)]
Cost of goods sold	2,000,000[(b)]
Profit	$ 200,000

(a) Revenue recognized is calculated as (20% x $3,500,000) + $1,500,000. ($3,500,000 million is $5,000,000 transaction price − $1,500,000 cost of elevator).

(b) Cost of goods sold is $500,000 of costs incurred + 1,500,000 costs of elevators

7.1.4.3 Examples

The following example illustrates some of the factors an entity may consider when determining an appropriate measure of progress:

Illustration 7-1: Choosing the measure of progress

A shipbuilding entity enters into a contract to build 15 vessels for a customer over a three-year period. The contract includes both design and production services. The entity has not built a vessel of this type before, and it expects that the first vessels may take longer to produce than the last vessels because, as the entity gains experience building the vessels, it expects to be able to construct them more efficiently.

Assume that the entity has determined that the design and production services represent a single performance obligation. In this situation, the entity would likely not choose a "units of delivery" method as a measure of progress because that method would not accurately reflect its level of performance. That is, such a method would not reflect the entity's efforts during the design phase of the contract because no revenue would be recognized until a vessel was shipped. In this situation, the entity would likely determine that an input method, such as a percentage of completion method based on costs incurred approach, is more appropriate.

The standard also includes the following example on selecting an appropriate measure of progress toward satisfaction of a performance obligation:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 18 — Measuring Progress When Making Goods or Service Available

606-10-55-184

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay $100 per month.

606-10-55-185

The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a).

606-10-55-186

The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress toward complete satisfaction of the performance obligation over time is a time-based measure, and it recognizes revenue on a straight-line basis throughout the year at $100 per month.

Question 7-3

How should an entity measure progress toward satisfaction of a stand-ready obligation that is satisfied over time? [26 January 2015 TRG meeting; agenda paper no. 16]

TRG members generally agreed that an entity should not default to a straight line revenue attribution model. However, they also generally agreed that if an entity expects the customer to receive and consume the benefits of its promise throughout the contract period, a time-based measure of progress (e.g., straight line) would be appropriate. The TRG agenda paper noted that this will generally be the case for unspecified upgrade rights, help desk support contracts and cable or satellite television contracts. TRG members generally agreed that ratable recognition may not be appropriate if the benefits are not spread evenly over the contract period (e.g., an annual snow removal contract that provides most benefits in winter).

Question 7-4 **Can multiple measures of progress be used to depict an entity's performance in transferring a performance obligation comprised of two or more non-distinct goods and/or services (i.e., a combined performance obligation[191]) that is satisfied over time?** [13 July 2015 TRG meeting; agenda paper no. 41]

TRG members agreed that when an entity has determined that a combined performance obligation is satisfied over time, the entity has to select a single measure of progress that faithfully depicts the entity's performance in transferring the goods or services. For example, using different measures of progress for different non-distinct goods or services in the combined performance obligation would be inappropriate because doing so ignores the unit of accounting that has been identified under the standard (i.e., the single combined performance obligation) and recognizes revenue in a way that overrides the separation and allocation guidance in the standard.

While TRG members didn't discuss this point, the TRG agenda paper noted that a single method of measuring progress should not be broadly interpreted to mean an entity may apply multiple measures of progress as long as all measures used are either output or input measures. TRG members also acknowledged that there is diversity in practice under legacy GAAP, and selecting a single measure of progress may represent a change for entities that have previously used a multiple attribution model when deliverables cannot be separated into separate units of accounting.

Question 7-5 **How should an entity determine the appropriate single measure of progress for a combined performance obligation that is satisfied over time?** [13 July 2015 TRG meeting; agenda paper no. 41]

TRG members acknowledged that it may be difficult to appropriately determine a single measure of progress when the entity will transfer goods or services that make up a combined performance obligation over different points of time and/or the entity would otherwise use a different measure of progress (e.g., a time-based method versus a labor-based input method) if each promise was a separate performance obligation. Such a determination will require significant judgment, but TRG members generally agreed that the measure of progress selected is not meant to be a "free choice," and that entities should consider the nature of the overall promise for the combined performance obligation in determining the measure of progress to use. For example, entities should not default to a "final deliverable" methodology such that all revenue would be recognized over the performance period of the last promised good or service. Rather, an entity is required to select the single measure of progress that most faithfully depicts the entity's performance in satisfying its combined performance obligation.

Some TRG members observed that an entity should consider the reasons why goods or services were bundled into a combined performance obligation in order to determine the appropriate pattern of revenue recognition. For example, if a good or service was combined with other goods or services because it was not capable of being distinct, that may indicate that it does not provide value or use to the customer on its own, and the entity should not contemplate the transfer of that good or service when determining the pattern of revenue recognition for the combined performance obligation.

TRG members also generally agreed that if an appropriately selected single measure of progress does not faithfully depict the economics of the arrangement, the entity should challenge whether the performance obligation was correctly combined (i.e., there might be more than one performance obligation).

[191] Under Step 2 of the model, a single performance obligation may contain multiple non-distinct goods or services and/or distinct goods or services that were required to be combined with other non-distinct goods or services in order to identify a distinct bundle. This bundled performance obligation is referred to as a "combined performance obligation" for purposes of this discussion.

Question 7-6 **Can control of a good or service underlying a performance obligation satisfied over time be transferred at discrete points in time?** [18 April 2016 FASB TRG meeting; agenda paper no. 53]

FASB TRG members generally agreed that if a performance obligation meets the criteria for revenue to be recognized over time (rather than at a point in time), control of the underlying good or service is not transferred at discrete points in time. Because control transfers as an entity performs, an entity's performance (as reflected using an appropriate measure of progress) should not result in the creation of a material asset on the entity's books (e.g., work in progress).

Stakeholders had asked whether control of a good or service underlying a performance obligation that is satisfied over time can be transferred at discrete points in time because the standards highlight several output methods, including "milestones reached," as potentially acceptable methods for measuring progress toward satisfaction of an over-time performance obligation. FASB TRG members generally agreed that an entity could use an output method only if that measure of progress correlates to the entity's performance to date.

Question 7-7 **Can an entity use the "right to invoice" practical expedient for a contract that includes rates that change over the contractual term?** [13 July 2015 TRG meeting; agenda paper no. 40]

TRG members generally agreed that determining whether an entity can apply the "right to invoice" practical expedient will require judgment. They also generally agreed that it is possible for entities to meet the requirements for the practical expedient in contracts with changing rates, provided that the changing rates correspond directly to changes in value to the customer. That is, a contract does not need to have a fixed price per unit for the duration of a contract in order to qualify for the practical expedient. Examples of contracts that might qualify include an IT outsourcing arrangement with rates that decrease over the contract term as the level of effort to the customer decreases or a multi-year electricity contract that contemplates the forward market price of electricity. However, the SEC Observer also noted that entities will need to have strong evidence that variable prices reflect value to the customer in order to recognize variable amounts of revenue for similar goods or services.

Question 7-8 **If an entity begins activities on a specifically anticipated contract either (1) before it agrees to the contract with the customer or (2) before the arrangement meets the criteria to be considered a contract under the standard, how should revenue be recognized at the date a contract exists?** [30 March 2015 TRG meeting; agenda paper no. 33]

TRG members generally agreed that if the goods or services that ultimately will be transferred meet the criteria to be recognized over time, revenue should be recognized on a cumulative catch-up basis at the "contract establishment date," reflecting the performance obligation(s) that are partially or fully satisfied at that time. The TRG agenda paper noted that the cumulative catch-up method is considered to be consistent with the overall principle of the standard that revenue should be recognized when (or as) an entity transfers control of goods or services to a customer.

Question 7-9 **How should an entity account for fulfillment costs incurred prior to the contract establishment date that are outside the scope of another standard (e.g., outside of the scope of the inventory guidance in ASC 330)?** [30 March 2015 TRG meeting; agenda paper no. 33]

See response to Question 9-13 in Section 9.3.2.

7.2 Control transferred at a point in time

For all performance obligations for which control is not transferred over time, control is transferred at a point in time. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in other circumstances, this determination is more complex.

To help entities determine the point in time when a customer obtains control of a particular good or service, the FASB provided the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied at a Point in Time

606-10-25-30

If a **performance obligation** is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a **customer** obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset — If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

b. The customer has legal title to the asset — Legal title may indicate which party to a **contract** has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

c. The entity has transferred physical possession of the asset — The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

d. The customer has the significant risks and rewards of ownership of the asset — The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

e. The customer has accepted the asset — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

None of the indicators above are meant to individually determine whether the customer has gained control of the good or service. For example, while shipping terms may provide information about when legal title to a good transfers to the customer, they are not determinative when evaluating the point in time at which the customer obtains control of the promised asset. An entity must consider all relevant facts and circumstances to determine whether control has transferred. The FASB also clarified[192] that the indicators are not meant to be a checklist, and not all of them must be present for an entity to determine that the customer has gained control. Rather, the indicators are factors that are often present when a customer has obtained control of an asset, and the list is meant to help entities apply the principle of control.

Present right to payment for the asset

As noted in the Basis for Conclusions of ASU 2014-09,[193] the FASB considered but rejected specifying a right to payment as an overarching criterion for determining when revenue should be recognized. Therefore, while the date at which the entity has a right to payment for the asset may be an indicator of the date the customer obtained control of the asset, it does not always indicate that the customer has obtained control of the asset. For example, in some contracts, a customer is required to make a nonrefundable up-front payment but receives no goods or services in return at that time.

Legal title and physical possession

The term "title" is often associated with a legal definition denoting the ownership of an asset or legally recognized rights that preclude others' claim to the asset. Accordingly, the transfer of title often indicates that control of an asset has been transferred. Determination of which party has title to an asset does not always depend on which party has physical possession of the asset, but without contract language to the contrary, title generally passes to the customer at the time of the physical transfer. For example, in a retail store transaction, there is no clear documentation of the title transfer. However, it is understood that product title is transferred at the time of purchase by the customer.

While the retail store transaction is relatively straightforward, determining when title has transferred may be more complicated in other arrangements. Transactions that involve the shipment of products may have varying shipment terms and often involve third-party shipping agents. In such cases, a clear understanding of the seller's practices and the contractual terms of an arrangement is required in order to make an assessment of when title transfers. As indicated in ASC 606-10-25-30(b), legal title and/or physical possession may be an indicator of which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits.

Risks and rewards of ownership

Although the Board included the risks and rewards of ownership as one factor to consider when evaluating whether control of an asset has transferred, it emphasized in the Basis for Conclusions of ASU 2014-09[194] that this factor does not change the principle of determining the transfer of goods or

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[192] Paragraph BC155 of ASU 2014-09.
[193] Paragraph BC148 of ASU 2014-09.
[194] Paragraph BC154 of ASU 2014-09.

services on the basis of control. The concept of the risks and rewards of ownership is based on how the seller and the customer share both the potential gain (the reward) and the potential loss (risk) associated with owning an asset. Rewards of ownership include the following:

- Rights to all appreciation in value of the asset
- Unrestricted usage of the asset
- Ability to modify the asset
- Ability to transfer or sell the asset
- Ability to grant a security interest in the asset

Conversely, the risks of ownership include the following:

- Absorbing all of the declines in market value
- Incurring losses due to theft or damage of the asset
- Incurring losses due to changes in the business environment (e.g., obsolescence, excess inventory, effect of retail pricing environment)

However, as noted in ASC 606-10-25-30(d), an entity should not consider risks that give rise to a separate performance obligation when evaluating whether the entity has the risks of ownership of an asset. For example, an entity does not consider warranty services that represent a separate performance obligation when evaluating whether it retains the risks of ownership of the asset sold to the customer.

7.2.1 Customer acceptance

When determining whether the customer has obtained control of the goods or services, an entity must consider any customer acceptance clauses that require the customer to approve the goods or services before it is obligated to pay for them. If a customer does not accept the goods or services, the entity may not be entitled to consideration, may be required to take remedial action or may be required to take back the delivered good.

The standard provides the following guidance on how customer acceptance provisions should be evaluated:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Customer Acceptance

606-10-55-85

In accordance with paragraph 606-10-25-30(e), a **customer's** acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a **contract** or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity should consider such clauses when evaluating when a customer obtains control of a good or service.

606-10-55-86

If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If **revenue** is recognized before customer acceptance, the entity still must consider whether there are any remaining **performance obligations** (for example, installation of equipment) and evaluate whether to account for them separately.

606-10-55-87

However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because, in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

606-10-55-88

If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

Some acceptance provisions may be straightforward and may give a customer the ability to accept or reject delivered products based on standard objective criteria specified in the contract (e.g., the goods function at a specified speed). Other acceptance clauses may be subjective or may appear in parts of the contract that do not typically address acceptance matters, such as warranty provisions or indemnification clauses. Professional judgment may be required to determine the effect of the latter types of acceptance clauses on revenue recognition.

Acceptance criteria that an entity cannot objectively evaluate against the agreed-upon specifications in the contract will preclude an entity from concluding that a customer has obtained control of a good or service until formal customer sign-off is obtained, or the acceptance provisions lapse. Further, the entity should consider its experience with other contracts for similar goods or services because that experience may provide evidence that the entity is able to objectively determine that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. We believe one or more of the following would represent circumstances in which the entity may not be able to objectively evaluate the acceptance criteria:

- The acceptance provisions are unusual, or "non-standard." Indicators of "non-standard" acceptance terms are:
  - The duration of the acceptance period is longer than in standard contracts
  - The majority of the vendor's contracts lack similar acceptance terms
  - The arrangement contains explicit customer-specified requirements that must be met prior to acceptance
- The arrangement contains a contractual requirement for explicit notification of acceptance versus deemed acceptance. Explicit notification requirements may indicate that the criteria the customer is assessing are not objective. Contracts may include provisions used to limit the time period the customer has to reject delivered products. Such clauses may require the customer to provide, in writing, the reasons for the rejection of the products by the end of a specified period. When such clauses exist, acceptance can be deemed to have occurred at the end of the specified time period if notification of rejection has not been received from the customer, as long as the customer has not indicated it will reject the products.

In determining whether the criteria for acceptance can be objectively assessed and acceptance is only a formality, the following criteria should be considered:

- Whether the acceptance terms are standard in arrangements entered into by the vendor
- Whether the acceptance is based on the delivered product performing to standard published specifications, and whether the vendor can demonstrate that it has an established history of objectively determining that the product functions in accordance with those specifications
- Whether the vendor is required to perform additional services for customer acceptance to occur

As discussed above, customer acceptance should not be deemed a formality if the acceptance terms are unusual or non-standard. If an arrangement contains acceptance provisions based on customer-specified criteria, it may be difficult for the entity to objectively assess the criteria, and the entity should not recognize revenue prior to obtaining written evidence of customer acceptance. However, determining that the acceptance criteria have been met (and thus acceptance is merely a formality) may be appropriate if the entity can demonstrate that its product meets all of the customer's acceptance specifications by replicating, before shipment, those conditions under which the customer intends to use the product.

However, if the product's performance, once it has been installed and is operating at the customer's facility, may reasonably be expected to be different from the performance as tested prior to shipment, this acceptance provision has not been met. The entity therefore would not be able to conclude that the customer has obtained control until customer acceptance occurs. Factors indicating that specifications cannot be tested effectively prior to shipment include:

- The customer has unique equipment, software or environmental conditions that can reasonably be expected to make performance in that customer's environment different from testing performed by the vendor. If the arrangement includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's site, revenue recognition should be deferred until it can be demonstrated that the criteria are met
- The products that are the subject of the arrangement are highly complex
- The vendor has a limited history of testing products prior to delivery to customers, or a limited history of having customers reject products that it has previously tested

Determining when a customer obtains control of an asset in an arrangement with customer-specified acceptance criteria requires the use of professional judgment and depends on the weight of the evidence in the particular circumstances. The conclusion could change based on a single variable such as the complexity of the equipment, the nature of the interface with the customer's environment, the extent of the seller's experience with this type of transaction or a particular clause in the agreement. An entity may need to discuss the situation with knowledgeable project managers or engineers in making such an assessment.

Additionally, each contract containing customer-specified acceptance criteria may require a separate assessment of whether the acceptance provisions have been met prior to confirmation of the customer's acceptance. That is, because different customers may specify different acceptance criteria, a vendor may not be able to make one assessment that applies to all contracts because of the variations in contractual terms and customer environments.

Even if an arrangement includes a standard acceptance clause, if the clause relates to a new product, or one that has only been sold on a limited basis previously, a vendor may be required to initially defer revenue recognition for the product until it establishes a history of successfully obtaining acceptance.

7.3 Repurchase agreements

Some agreements include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods. These provisions affect how an entity applies the guidance on control to affected transactions.

The standard clarifies the types of arrangements that qualify as repurchase agreements:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Satisfaction of Performance Obligations

606-10-25-26

When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs 606-10-55-66 through 55-78).

Implementation Guidance and Illustrations

Repurchase Agreements

606-10-55-66

A repurchase agreement is a **contract** in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the **customer**, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

606-10-55-67

Repurchase agreements generally come in three forms:

a. An entity's obligation to repurchase the asset (a forward)

b. An entity's right to repurchase the asset (a call option)

c. An entity's obligation to repurchase the asset at the customer's request (a put option).

In order for an obligation or right to purchase an asset to be accounted for as a repurchase agreement under the standard, it should exist at contract inception either as a part of the same contract or in another contract. The FASB clarified[195] that an entity's subsequent decision to repurchase an asset after transferring control of that asset to a customer without reference to any pre-existing contractual right should not be accounted for as a repurchase agreement under the standard. That is, because the customer is not obligated to resell that good to the entity as a result of the initial contract, any subsequent decision to repurchase the asset does not affect the customer's ability to control the asset upon initial transfer. However, in cases in which an entity decides to repurchase a good after transferring control of the good to a customer, the Board observed that the entity should carefully consider whether the customer obtained control in the initial transaction and may need to consider the guidance on principal versus agent considerations (see Section 4.4).

[195] Paragraph BC423 of ASU 2014-09.

7.3.1 Forward or call option held by the entity

When an entity has the obligation or right to repurchase an asset (i.e., a forward or call option), the standard indicates that the customer has not obtained control of the asset. Instead, the standard provides the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

A Forward or a Call Option

606-10-55-68

If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a **customer** does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the **contract** as either of the following:

a. A lease in accordance with Topic 840 on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 840-40.

b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

606-10-55-69

When comparing the repurchase price with the selling price, an entity should consider the time value of money.

606-10-55-70

If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer. The entity should recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).

606-10-55-71

If the option lapses unexercised, an entity should derecognize the liability and recognize **revenue**.

This guidance requires that an entity account for a transaction including a forward or a call option based on the relationship between the repurchase price and the original selling price. The standard indicates that if the entity has the right or obligation to repurchase the asset at a price less than the original sales price (taking into consideration the effects of the time value of money), the entity would account for the transaction as a lease in accordance with ASC 840 (or ASC 842 upon adoption of ASU 2016-02), unless the contract is part of a sale-leaseback transaction. If the entity has the right or obligation to repurchase the asset at a price equal to or greater than the original sales price (considering the effects of the time value of money) or if the contract is part of a sale-leaseback transaction, the entity would account for the contract as a financing arrangement in accordance with ASC 606-10-55-70.

The following graphic depicts this guidance for transactions that are not sale-leasebacks:

Forward or call option

Repurchase price	$<$	Original selling price	=	Lease
Repurchase price	$\geq$	Original selling price	=	Financing

Under the standard, *any* transaction with a seller option to repurchase the product must be treated as a lease or a financing arrangement (i.e., not a sale) because the customer does not have control of the product and is constrained in its ability to direct the use of and obtain substantially all of the remaining benefits from the good. That is, entities cannot consider the likelihood that a call option will be exercised in determining the accounting for the repurchase provision. However, the Board noted in the Basis for Conclusions of ASU 2014-09[196] that nonsubstantive call options should be ignored and would not affect when a customer obtains control of an asset.

If a transaction is considered a financing arrangement under the standard, in accordance with ASC 606-10-55-70, the selling entity will continue to recognize the asset and record a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration subsequently paid to the customer (upon repurchasing the asset) will represent the interest and holding costs, as applicable, that will be recognized over the term of the financing arrangement. If the option lapses unexercised, the entity will derecognize the liability and recognize revenue at that time.

How we see it

Because the standard treats all forwards and call options the same way and does not consider their likelihood of exercise, some entities may experience a significant change in practice. In addition, given that the FASB has embedded lease guidance in the standard, it will be important for entities to understand the interaction between the lease and revenue guidance. Lastly, the standard does not differ significantly from legacy GAAP (i.e., ASC 470-40) on product financing arrangements for many transactions. However, entities that retain an option to repurchase a good from the customer as a part of a sales contract may see a change in practice.

The standard provides the following example of a call option:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 62 — Repurchase Agreements

606-10-55-401

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

[196] Paragraph BC427 of ASU 2014-09.

Case A — Call Option: Financing

606-10-55-402

The contract includes a call option that gives the entity the right to repurchase the asset for $1.1 million on or before December 31, 20X7.

606-10-55-403

Control of the asset does not transfer to the customer on December 31, 20X7, because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph 606-10-55-68(b), the entity accounts for the transaction as a financing arrangement because the exercise price is more than the original selling price. In accordance with paragraph 606-10-55-70, the entity does not derecognize the asset and instead recognizes the cash received as a financial liability. The entity also recognizes interest expense for the difference between the exercise price ($1.1 million) and the cash received ($1 million), which increases the liability.

606-10-55-404

On December 31, 20X7, the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.

7.3.2 Put option held by the customer

An entity's obligation to repurchase an asset at the customer's request is a put option that is held by the customer. The standard provides the following guidance for customer-held put options:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

A Put Option

606-10-55-72

If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 840 on leases unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 840-40.

606-10-55-73

To determine whether a customer has a significant economic incentive to exercise its right, an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option.

606-10-55-74

If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

606-10-55-75

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, should be accounted for as described in paragraph 606-10-55-70.

606-10-55-76

If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

606-10-55-77

When comparing the repurchase price with the selling price, an entity should consider the time value of money.

606-10-55-78

If the option lapses unexercised, an entity should derecognize the liability and recognize **revenue**.

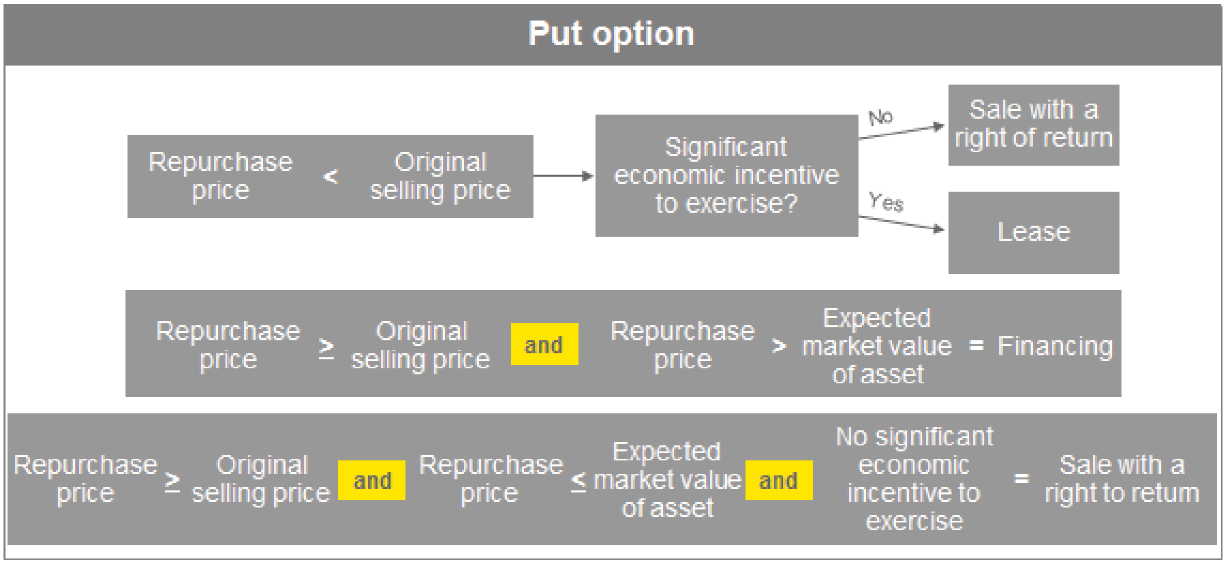
The standard indicates that if the customer has the ability to require an entity to repurchase an asset (i.e., a put option) at a price lower than the original selling price, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. That is, this determination influences whether the customer truly has control over the asset received and will determine whether the arrangement is treated as a lease or a sale with the right of return (see Section 5.4.1). An entity must consider many factors to determine whether a customer has a significant economic incentive to exercise its right, including the relationship of the repurchase price to the expected market value of the asset at the date of repurchase and the amount of time until the right expires. The standard notes that if the repurchase price is expected to significantly exceed the market value of the asset, the customer has a significant economic incentive to exercise the put option.

If a customer has a significant economic incentive to exercise its right and, therefore, the customer is expected to ultimately return the asset, the entity should account for the agreement as a lease because the customer is effectively paying the entity for the right to use the asset for a period of time. An exception would be if the contract is part of a sale-leaseback, in which case the contract should be accounted for as a financing arrangement in accordance with ASC 606-10-55-70.

If a customer does not have a significant economic incentive to exercise its right, the entity should account for the agreement in a manner similar to a sale of a product with a right of return. A repurchase price of an asset that is equal to or greater than the original selling price but less than or equal to the expected market value of the asset should also be accounted for as a sale of a product with a right of return, if the customer does not have a significant economic incentive to exercise its right. See Section 5.4.1 for a discussion of sales with a right of return.

If the customer has the ability to require an entity to repurchase the asset at a price equal to or more than the original selling price and the repurchase price is more than the expected market value of the asset, the contract is in effect a financing arrangement.

The following graphic depicts this guidance:



How we see it

The guidance in the standard on put options is different from legacy GAAP because it requires an entity to determine whether the customer has a significant economic incentive to exercise its right. Under legacy GAAP, when an arrangement includes a put option that is designed to compensate the customer for holding costs (including interest), the arrangement is accounted for as a financing arrangement, regardless of whether the customer is likely to exercise that option. However, the standard provides limited guidance on determining whether "a significant economic incentive" exists, and judgment may be required to make this determination.

The standard provides the following example of a put option:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 62 — Repurchase Agreements

606-10-55-401

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

Case B — Put Option: Lease

606-10-55-405

Instead of having a call option, the contract includes a put option that obliges the entity to repurchase the asset at the customer's request for $900,000 on or before December 31, 20X7. The market value is expected to be $750,000 on December 31, 20X7.

606-10-55-406

At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs 606-10-55-72 through 55-78). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

606-10-55-407

In accordance with paragraphs 606-10-55-72 through 55-73, the entity accounts for the transaction as a lease in accordance with Topic 840 on leases.

Question 7-10 **When an entity has a conditional call option to remove and replace expired products (e.g., out-of-date perishable goods, expired medicine), does the customer obtain control of the products (or is it akin to a right of return)?**

The standard does not differentiate a conditional call or forward option from an unconditional one and states that a customer does not obtain control of the asset when the entity has a right to repurchase the asset. The presence of call or forward options indicates that control is not transferred because the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

However, in the case of perishable products, an entity's conditional right to remove and replace expired goods does not necessarily constrain the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the products. That is, the entity is not able to remove and replace the products until they expire, and the customer has control of the products over their entire useful life. Consequently, we believe it may be reasonable for an entity to conclude that control of the initial product does transfer to the customer in this situation and to consider this right to be a form of a right of return (see Section 5.4.1).

7.3.3 Sales with residual value guarantees

An entity that sells equipment may guarantee that the customer will receive a minimum resale amount when the customer resells the equipment (i.e., a residual value guarantee). The FASB explained in the Basis for Conclusions of ASU 2014-09[197] that it considered whether such arrangements should be accounted for as a lease under the new standard, which would be consistent with the treatment under legacy GAAP. However, the FASB explained that while the economics of a repurchase agreement and a residual value guarantee may be similar, the customer's ability to control the asset in each case would be different. If the customer holds a put option that it has significant economic incentive to exercise, the customer is effectively restricted in its ability to consume, modify or sell the asset. In contrast, when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset. Accordingly, the Board decided that it was not necessary to expand the guidance on repurchase agreements to consider guaranteed amounts of resale.

[197] Paragraph BC431 of ASU 2014-09.

Therefore, it will be important for an entity to review all its contracts and make sure that the residual value guarantee is not accomplished through a repurchase provision such as a put within the contract (e.g., the customer has the right to require the entity to repurchase equipment two years after the date of purchase at 85% of the original purchase price). If a put option is present, the entity would have to account for such a contract under the repurchase agreement guidance above and determine whether the existence of the put precludes the customer from obtaining control of the acquired item. In doing so, the entity would determine whether the customer has a significant economic incentive to exercise the put. If the entity concludes that there is no significant economic incentive, the transaction would be accounted for as a sale with a right of return as discussed in Section 7.3.2. Alternatively, if the entity concludes there is a significant economic incentive for the customer to exercise its right, the transaction would be accounted for as a lease.

If the transaction includes a residual value guarantee in which no put option is present and the entity will make the customer whole if, for example, the customer receives less than 85% of the initial sale price in a qualifying future sale to a third party, the repurchase agreement guidance in the standard would not apply because the entity is not repurchasing the asset from the customer. In those situations, the entity likely will need to account for the residual value guarantee under the guidance in ASC 460 (see Question 7-11 below) and the remainder of the transaction will be accounted for as a sale of the asset under the revenue guidance.

Question 7-11 **Is a residual value guarantee, which is provided by an entity to a customer (that does not require the entity to reacquire the product sold), a financial guarantee in the scope of ASC 460?**

Yes, we believe a residual value guarantee is a financial guarantee within the scope of ASC 460. To account for such arrangements, the entity should bifurcate the guarantee at fair value (and account for it under ASC 460) and account for the remaining amount of consideration under ASC 606.

Consider an auto manufacturer that sells vehicles to a fleet customer under a contract that includes a guaranteed auction value (i.e., a guaranteed minimum resale value). The fleet customer takes title to each vehicle at time of sale, and title remains with the fleet customer until resale. Upon resale by the fleet customer, to the extent the resale price is below the guaranteed minimum resale value, the auto manufacturer agrees to pay the fleet customer the difference between the resale proceeds received and the guaranteed minimum resale value. The guaranteed minimum resale value is agreed to at the inception of the contract and is a fixed amount.

The contract does not include a repurchase agreement as defined in ASC 606-10-55-56 because the title does not revert back to the auto manufacturer at any time. ASC 460-10-15-4(a) notes that contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying are within the scope of ASC 460. The guarantee from the auto manufacturer to the fleet customer represents such a financial guarantee.

In addition, consequential amendments made to ASC 840-10-55-14A due to ASU 2014-09 state that "a sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it will pay a purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value should be accounted for in accordance with Topic 460 on guarantees and Topic 606 on revenue from contracts with customers."

7.4 Consignment arrangements

Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor, dealer). By shipping on a consignment basis, consignors are able to better market products by moving them closer to the end user; however, they do so without selling the goods to the intermediary (consignee).

The standard provides the following guidance for determining whether an arrangement is a consignment arrangement:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Consignment Arrangements

606-10-55-79

When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end **customers**, the entity should evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity should not recognize **revenue** upon delivery of a product to another party if the delivered product is held on consignment.

606-10-55-80

Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

a. The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.

b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).

c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Entities entering into a consignment arrangement must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the product/good to the consignee or to transfer the product to the end customer). This determination should be based on whether control of the product passes to the consignee upon delivery. Typically, a consignor will not relinquish control of the consigned product until the product is sold to the end consumer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the product other than to pay the consignor the agreed-upon portion of the sale price once the consignee sells the product to a third party. As a result, revenue generally would not be recognized for consignment arrangements when the products are delivered to the consignee because control has not transferred (i.e., the performance obligation to deliver goods to the end customer has not yet been satisfied).

7.5 Bill-and-hold arrangements

In some sales arrangements, an entity fulfills its obligations and bills the customer for the work performed but does not ship the goods until a later date. These arrangements, often called "bill-and-hold," usually are designed this way at the request of the customer for a number of reasons, including a lack of storage capacity or its inability to use the goods until a later date.

The criteria for determining whether a bill-and-hold arrangement qualifies for revenue recognition under the standard are similar to, but somewhat less detailed than, the criteria in SAB Topic 13,[198] Securities Exchange Act Release 23507, Accounting and Auditing Enforcement Release No. 108 and SEC Release Nos. 33-8642, 34-52885 and IC-27178. For example, the requirement in SAB Topic 13 that the arrangement include a fixed delivery schedule is not a consideration under the standard.

The standard provides the following guidance with respect to these arrangements:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Bill-and-Hold Arrangements

606-10-55-81

A bill-and-hold arrangement is a **contract** under which an entity bills a **customer** for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

606-10-55-82

An entity should determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 606-10-25-30). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

606-10-55-83

In addition to applying the guidance in paragraph 606-10-25-30, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

606-10-55-84

If an entity recognizes **revenue** for the sale of a product on a bill-and-hold basis, the entity should consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 606-10-25-14 through 25-22 to which the entity should allocate a portion of the **transaction price** in accordance with paragraphs 606-10-32-28 through 32-41.

[198] The SEC staff has been reviewing its revenue guidance in light of the new standard and has rescinded four SEC Staff Observer comments on narrow issues related to revenue effective upon adoption of the new standard. However, it hasn't yet addressed what will happen with SAB Topic 13.

The standard provides the following example to illustrate the bill-and-hold guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 63 — Bill-and-Hold Arrangement

606-10-55-409

An entity enters into a contract with a customer on January 1, 20X8, for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

606-10-55-410

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On December 31, 20X9, the customer pays for the machine and spare parts but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts, and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse, and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years, and the entity does not have the ability to use the spare parts or direct them to another customer.

606-10-55-411

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts, and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognized when (or as) control transfers to the customer.

606-10-55-412

Control of the machine transfers to the customer on December 31, 20X9, when the customer takes physical possession. The entity assesses the indicators in paragraph 606-10-25-30 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts, and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria in paragraph 606-10-55-83 are met, which is necessary for the entity to recognize revenue in a bill-and-hold arrangement. The entity recognizes revenue for the spare parts on December 31, 20X9, when control transfers to the customer.

606-10-55-413

The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity considers whether the payment terms include a significant financing component in accordance with paragraphs 606-10-32-15 through 32-20.

7.6 Recognizing revenue for licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of intellectual property that differs from the recognition model for other promised goods and services. We discuss licensing in detail in Chapter 8.

7.7 Recognizing revenue when a right of return exists

As discussed in Section 4.7, a right of return does not represent a separate performance obligation. Instead, the existence of a right of return affects the transaction price, and the entity must determine whether the customer will return the transferred product.

Under the standard, as discussed in Chapter 5, an entity will estimate the transaction price and apply the constraint to the estimated transaction price. In doing so, it will consider the products expected to be returned to determine the amount to which the entity expects to be entitled (excluding consideration for the products expected to be returned). The entity will recognize revenue based on the amount to which it expects to be entitled through the end of the return period (considering expected product returns). An entity will not recognize the portion of the revenue subject to the constraint until the amount is no longer constrained, which could be at the end of the return period or earlier if the entity's expectations about the products expected to be returned changes prior to the end of the return period. The entity will recognize the amount received or receivable that is expected to be returned as a refund liability, representing its obligation to return the customer's consideration. An entity also will update its estimates at each financial reporting date. See Sections 4.7 and 5.4.1 for further discussion on rights of return.

7.8 Recognizing revenue for customer options for additional goods and services

As discussed in Section 4.6, when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services and the entity will be required to allocate a portion of the transaction price to the material right at contract inception (see Section 6.1.5). The revenue allocated to the material right will be recognized when (or as) the option is exercised (and the underlying future goods or services are transferred) or when the option expires.

In contrast, if a customer option is not deemed to be a material right and is instead a marketing offer, there is no accounting for the option and no accounting for the underlying goods or services until those subsequent purchases occur.

Question 7-12 **How should an entity account for the exercise of a material right? That is, should it be accounted for as a contract modification, a continuation of the existing contract or as variable consideration?** [30 March 2015 TRG meeting; agenda paper no. 32]

See response to Question 4-16 in Section 4.6.

7.9 Breakage and prepayments for future goods or services

In certain industries, an entity will collect nonrefundable payments from its customers for goods or services that the customer has a right to receive in the future. However, a customer may ultimately leave that right unexercised (often referred to as breakage). For example, retailers frequently sell gift cards that are not completely redeemed, and airlines sometimes sell tickets to passengers who allow the tickets to expire unused.

The standard provides the following guidance on accounting for customers' unexercised rights:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance

Customers' Unexercised Rights

606-10-55-46

In accordance with paragraph 606-10-45-2, upon receipt of a prepayment from a **customer**, an entity should recognize a **contract liability** in the amount of the prepayment for its **performance obligation** to transfer, or to stand ready to transfer, goods or services in the future. An entity should derecognize that contract liability (and recognize **revenue**) when it transfers those goods or services and, therefore, satisfies its performance obligation.

606-10-55-47

A customer's nonrefundable prepayment to an entity gives the customer a right to receive a good or service in the future (and obliges the entity to stand ready to transfer a good or service). However, customers may not exercise all of their contractual rights. Those unexercised rights are often referred to as breakage.

606-10-55-48

If an entity expects to be entitled to a breakage amount in a contract liability, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine whether an entity expects to be entitled to a breakage amount, the entity should consider the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

606-10-55-49

An entity should recognize a liability (and not revenue) for any consideration received that is attributable to a customer's unexercised rights for which the entity is required to remit to another party, for example, a government entity in accordance with applicable unclaimed property laws.

As stated above, when an entity receives consideration that is attributable to a customer's unexercised rights, the entity should recognize a contract liability equal to the amount prepaid by the customer for the performance obligation to transfer, or to stand ready to transfer, goods or services in the future. Revenue normally would be recognized when the entity satisfies it performance obligation

Since entities will frequently not be required by customers to fully satisfy their performance obligations, the Board concluded[199] that an entity that expects to be entitled to a breakage amount should recognize breakage as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, it should not recognize any breakage amounts as revenue until the likelihood of the customer exercising its right becomes remote. In estimating any breakage amount, an entity has to consider the constraint on variable consideration, as discussed in Section 5.2.3. That is, if it is probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity should not recognize those amounts until the breakage amounts are no longer constrained.

[199] Paragraph BC398 of ASU 2014-09.

As discussed above, the guidance on breakage requires that an entity establish a liability for the full amount of the prepayment and recognize breakage on that liability as revenue proportionate to the pattern of rights exercised by the customer. If the prepayment element (e.g., the sale of a gift card, loyalty points) is one of multiple performance obligations identified in a contract, an allocation of the transaction price will need to be made between the identified performance obligations so the amount deferred as a contract liability may differ from the amount of prepayment received for the unsatisfied performance obligations. The following example depicts the sale of goods with loyalty points. In this example, the amount allocated to the points (i.e., the "prepaid" element) is less than the standalone selling price of those points due to the allocation of the transaction price among the two performance obligation as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 52 — Customer Loyalty Program

606-10-55-353

An entity has a customer loyalty program that rewards a customer with 1 customer loyalty point for every $10 of purchases. Each point is redeemable for a $1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for $100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed, and the standalone selling price of the purchased products is $100,000. The entity expects 9,500 points to be redeemed. The entity estimates a standalone selling price of $0.95 per point (totalling $9,500) on the basis of the likelihood of redemption in accordance with paragraph 606-10-55-44.

606-10-55-354

The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation. The entity allocates the transaction price ($100,000) to the product and the points on a relative standalone selling price basis as follows:

Product	$91,324 [$100,000 × ($100,000 standalone selling price ÷ $109,500)]
Points	$8,676 [$100,000 × ($9,500 standalone selling price ÷ $109,500)]

606-10-55-355

At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognizes revenue for the loyalty points of $4,110 [(4,500 points ÷ 9,500 points) × $8,676] and recognizes a contract liability of $4,566 ($8,676 − $ 4,110) for the unredeemed points at the end of the first reporting period.

606-10-55-356

At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognizes revenue for the loyalty points of $3,493 {[(8,500 total points redeemed ÷ 9,700 total points expected to be redeemed) × $8,676 initial allocation] − $4,110 recognized in the first reporting period}. The contract liability balance is $1,073 ($8,676 initial allocation − $7,603 of cumulative revenue recognized).

Question 7-13 **Are customers' unexercised rights (i.e., breakage) a form of variable consideration?**

Although the breakage guidance in ASC 606-10-55-48 specifically refers to the constraint on variable consideration, we do not believe breakage is a form of variable consideration (see Section 5.2) because it does not affect the transaction price. Breakage is a recognition concept (Step 5) that could affect the timing of revenue recognition and is not a measurement concept (Step 3). For example, the transaction price for a sale of a $20 gift card is fixed at $20 regardless of the expected breakage amount. The expected breakage, however, could affect the timing of revenue recognition because an entity is required under ASC 606-10-55-48 to "recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer" if it expects to be entitled to a breakage amount.

8 Licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of intellectual property that differs from the recognition model for other promised goods and services. Because licenses include a wide array of features and economic characteristics, the Board decided that an entity will need to evaluate the nature of its promise to grant a license of intellectual property in order to determine whether the promise is satisfied (and revenue is recognized) over time or at a point in time. A license will either provide:

- A right to access the entity's intellectual property throughout the license period, which results in revenue that is recognized over time
- A right to use the entity's intellectual property as it exists at the point in time in which the license is granted, which results in revenue that is recognized at a point in time

The standard provides the following examples of intellectual property that may be licensed to a customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-54

A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology

b. Motion pictures, music, and other forms of media and entertainment

c. Franchises

d. Patents, trademarks, and copyrights.

The FASB emphasized in the Basis for Conclusions of ASU 2016-10[200] that a contract must include a license of intellectual property in order for an entity to apply the licensing implementation guidance. This may be a straightforward assessment for many contracts. However, entities may have to more carefully evaluate the nature of the rights conveyed or promises included in a contract. For example, a software hosting contract will only include a license to intellectual property if the following criteria in ASC 985-20-15-5(a) are met: the customer (1) has the contractual right to take possession of the software at any time during the hosting period without significant penalty and (2) can feasibly either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

The Board also noted[201] that entities are required to identify the promised goods and services and determine whether those goods and services are distinct for all contracts, including those that contain a license of intellectual property. The FASB concluded that it is not necessary to provide additional

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[200] Paragraph BC37 of ASU 2016-10.

[201] Paragraphs BC41 and 42 of ASU 2016-10.

guidance on identifying performance obligations specifically tailored to licenses of intellectual property. Instead, entities should apply the requirements of Step 2 of the model discussed in detail in Chapter 4 and in Section 8.1.

8.1 Identifying performance obligations in a licensing arrangement

Contracts for licenses of intellectual property frequently include explicit or implicit promises for additional goods and services (e.g., equipment, when-and-if available upgrades, maintenance, installation). Consistent with Step 2 of the general model (see Chapter 4), entities will need to apply the guidance on identifying performance obligations in paragraphs 606-10-25-14 through 25-22 when a contract with a customer includes a license of intellectual property and other promised goods or services in order to appropriately determine whether the license of intellectual property and the other promises are distinct (i.e., are separate performance obligations).

The standard provides the following guidance on identifying performance obligations in a licensing arrangement:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-55

In addition to a promise to grant a license (or licenses) to a **customer**, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the **contract** or implied by an entity's customary business practices, published policies, or specific statements (see paragraph 606-10-25-16). As with other types of contracts, when a contract with a customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity applies paragraphs 606-10-25-14 through 25-22 to identify each of the **performance obligations** in the contract.

As discussed in Section 4.2, the standard outlines a two-step process for determining whether a promised good or service (including a license of intellectual property) is distinct and, therefore, is a performance obligation: (1) consideration of the individual good or service (i.e., whether the good or service is capable of being distinct) and (2) consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct in the context of the contract).

To conclude that a good or service is distinct, an entity must determine that the good or service is both capable of being distinct and distinct in the context of the contract. These requirements must similarly be applied to determine whether a promise to grant a license of intellectual property is distinct from other promised goods or services in the contract. Therefore, entities are required to assess whether the customer can benefit from a license of intellectual property on its own or together with readily available resources (i.e., whether it is capable of being distinct) and whether the entity's promise to transfer a license of intellectual property is separately identifiable from other promises in the contract (i.e., whether it is distinct in the context of the contract).The assessment of whether a license of intellectual property is distinct will need to be based on the facts and circumstances of each contract.

8.1.1 Licenses of intellectual property that are distinct

Licenses frequently are capable of being distinct (i.e., the first criteria of a distinct good or service) as a customer often can obtain at least some benefit from the license of intellectual property on its own or with other readily available resources. Consider Example 11, Case A, from the standard (excerpted in full in Section 4.2.3), which includes a contract for a software license that is transferred along with installation services, technical support and software updates. The installation service is routinely performed by other entities and does not significantly modify the software. The software license is delivered before the other goods and services and remains functional without the updates and technical support. The entity concludes that the customer can benefit from each of the goods and services either on their own or together with other goods or services that are readily available. That is, each good or service, including the software license, is capable of being distinct under ASC 606-10-25-19(a).

If an entity determines that a license of intellectual property and other promised goods or services are capable of being distinct, the second step of the distinct evaluation is to determine whether they are distinct in the context of the contract. As part of this evaluation, an entity should consider the indicators for whether the goods or services are not separately identifiable including whether: (1) the entity provides a significant service of integrating the license and other goods or services into a combined output, (2) the license and other goods or services significantly modify or customize each other or (3) the license and other goods or services are highly interdependent or highly interrelated such that the entity would not be able to fulfill its promise to transfer the license independently of fulfilling its promise to transfer the other goods or services to the customer.

As part of their evaluation of the separately identifiable principle, entities also may need to consider the utility of the license of intellectual property and other promised goods or services in a contract (i.e., the ability of each good or service to provide benefit or value). As discussed in the Basis for Conclusions of ASU 2016-10,[202] an entity may be able to fulfill its promise to transfer each good or service in a contract independently of the other goods or services, but if each good or service significantly affects the other's utility to the customer, the promises would not be distinct in the context of the contract. This notion of utility is further discussed in Section 4.2.1.2 and in our discussion below on Example 10, Case C, in Section 8.1.2.

Continuing with Example 11, Case A, discussed above, the entity considers the separately identifiable principle and factors in ASC 606-10-25-21 and determines that the promise to transfer each good and service, including the software license, is separately identifiable. In reaching this determination, the entity considers that the installation services are routine and can be obtained from other providers. In addition, the software updates aren't necessary for the software to maintain a high level of utility to the customer during the license period. Therefore, neither the installation services nor the software updates significantly affect the customer's ability to use and benefit from the software license. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and services into one combined output. Lastly, the software and the services are not deemed to be highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates and the technical support.

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[202] Paragraph BC33(b) of ASU 2016-10.

The following example from the standard also illustrates a contract for which a license of intellectual property is determined to be distinct from other promised goods or services:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 56 — Identifying a Distinct License

606-10-55-367

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer for 5 years, while the customer develops its own manufacturing capability. The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical composition). There are no other promised goods or services in the contract.

Case B — License Is Distinct

606-10-55-371

In this case, the manufacturing process used to produce the drug is not unique or specialized, and several other entities also can also manufacture the drug for the customer.

606-10-55-372

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 606-10-25-19 are met for each of the license and the manufacturing service. The entity concludes that the criterion in paragraph 606-10-25-19(a) is met because the customer can benefit from the license together with readily available resources other than the entity's manufacturing service (that is, because there are other entities that can provide the manufacturing service) and can benefit from the manufacturing service together with the license transferred to the customer at the start of the contract.

606-10-55-372A

The entity also concludes that its promises to grant the license and to provide the manufacturing service are separately identifiable (that is, the criterion in paragraph 606-10-25-19(b) is met). The entity concludes that the license and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 606-10-25-21. In reaching this conclusion, the entity considers that the customer could separately purchase the license without significantly affecting its ability to benefit from the license. Neither the license nor the manufacturing service is significantly modified or customized by the other, and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the license and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the license independent of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the license and initially utilized a different manufacturer. Thus, although the manufacturing service necessarily depends on the license in this contract (that is, the entity would not contract for the manufacturing service without the customer having obtained the license), the license and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the license and to provide the manufacturing service are distinct and that there are two performance obligations:

a. License of patent rights

b. Manufacturing service.

606-10-55-373

The entity assesses the nature of its promise to grant the license. The entity concludes that the patented drug formula is functional intellectual property (that is, it has significant standalone functionality in the form of its ability to treat a disease or condition). There is no expectation that the entity will undertake activities to change the functionality of the drug formula during the license period. Because the intellectual property has significant standalone functionality, any other activities the entity might undertake (for example, promotional activities like advertising or activities to develop other drug products) would not significantly affect the utility of the licensed intellectual property. Consequently, the nature of the entity's promise in transferring the license is to provide a right to use the entity's functional intellectual property, and it accounts for the license as a performance obligation satisfied at a point in time. The entity recognizes revenue for the license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

606-10-55-374

In its assessment of the nature of the license, the entity does not consider the manufacturing service because it is an additional promised service in the contract. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time.

8.1.2 Licenses of intellectual property that are not distinct

The licenses of intellectual property included in the examples above were determined to be distinct as they met the two criteria of ASC 606-10-55-19. In other situations, a license of intellectual property may not be distinct from other promised goods or services in a contract, either because it is not capable of being distinct and/or it is not separately identifiable.

ASC 606-10-55-56 requires that a license that is not distinct from other promised goods or services in a contract be combined into a single performance obligation. It also identifies two examples of licenses of intellectual property that are not distinct from other goods or services as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-56

If the promise to grant a license is not distinct from other promised goods or services in the contract in accordance with paragraphs 606-10-25-18 through 25-22, an entity should account for the promise to grant a license and those other promised goods or services together as a single performance obligation. Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

a. A license that forms a component of a tangible good and that is integral to the functionality of the good

b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

In both examples, a customer only benefits from the combined output of the license of intellectual property and the related good or service and, therefore, the license is not distinct and would be combined with those other promised goods or services.

The standard includes other examples of non-distinct licenses of intellectual property that are combined with other promised goods or services because the customer can only benefit from the license in conjunction with a related service (as described in ASC 606-10-55-56(b)). For example, in Example 10, Case C (excerpted in full in Section 4.2.3), an entity grants a customer a license to antivirus software and promises to provide the customer with when-and-if available updates to that software during the three-year license period. The entity concludes that the license of intellectual property is capable of being distinct because the customer can obtain some limited benefit from the license without the updates. However, when evaluating whether the license is distinct in the context of the contract, the entity concludes that its promises to transfer the license and to provide the when-and-if available updates are not separately identifiable. This is because the license and the updates are effectively inputs to a combined item (i.e., antivirus protection) promised to the customer in the contract. The entity notes as part of its evaluation that the updates significantly modify the functionality of the software in that they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously and are integral to maintaining the utility of the software license to the customer. That is, without the updates, the customer's ability to benefit from the software would decline significantly over the license period. Accordingly, the entity accounts for the software license and the when-and-if available updates as a single performance obligation.

This example from the standard (Example 10, Case C) illustrates how the notion of "utility" (discussed above) can affect the determination of whether a license is distinct from other promised goods or services in a contract. Example 55 and Example 56, Case A, from the standard also illustrate contracts that include licenses of intellectual property that are not distinct from other goods or services promised to the customer. Example 56, Case A is excerpted below in Section 8.2.4.

To the extent that an entity is required to bundle a license of intellectual property with other promised goods and services in a contract, it will need to consider the licenses guidance to help determine the nature of its promise to the customer. See Section 8.2.4 for further discussion.

8.1.3 Contractual restrictions

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that clarified that entities will need to distinguish between contractual provisions that define the attributes of a single promised license (e.g., restrictions of time, geography or use) and contractual provisions that require them to transfer additional goods or services to customers (e.g., additional rights to use or access intellectual property).

The standard requires entities to distinguish between contractual provisions that define the attributes of a license of intellectual property (e.g., restrictions of time, geography or use) and other provisions in the contract that represent additional promised goods or services to the customer. Contractual provisions that are attributes of a promised license define the scope of a customer's rights to intellectual property and do not affect whether a performance obligation is satisfied at a point in time or over time or affect the number of performance obligations in the contract.

The following excerpt from the standard describes the requirement to evaluate restrictions on a license of intellectual property:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-64

Contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer (for example, by requiring the entity to transfer control of additional rights to use or rights to access intellectual property that the customer does not already control) should be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its **performance obligation** at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property.

The Board noted in the Basis for Conclusions of ASU 2016-10[203] that judgment often is required to distinguish a single promised license with multiple attributes from a license that contains multiple promises to the customer. If an entity determines that a license contains multiple promises to a customer, it will need to evaluate whether the multiple promises represent multiple performance obligations. The guidance on contractual restrictions in ASC 606-10-55-64 does not replace the requirement to appropriately identify the goods or services promised to the customer in accordance with Step 2 of the model (see Chapter 4).

When analyzing contractual restrictions, an entity should consider whether a restriction requires it to grant additional rights to the customer at a future date in order to fulfill its promises under the contract. The presence of a requirement to grant additional rights to the customer indicates that there may be multiple promises that need to be accounted for under Step 2 of the model.

The standard includes several examples that illustrate the application of the guidance on contractual restrictions, including Example 59 (included in Section 8.4 below) and Example 61B below:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 61B — Distinguishing Multiple Licenses from Attributes of a Single License

606-10-55-399K

On December 15, 20X0, an entity enters into a contract with a customer that permits the customer to embed the entity's functional intellectual property in two classes of the customer's consumer products (Class 1 and Class 2) for five years beginning on January 1, 20X1. During the first year of the license period, the customer is permitted to embed the entity's intellectual property only in Class 1. Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is permitted to embed the entity's intellectual property in Class 2. There is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period. There are no other

[203] Paragraph BC46 of ASU 2016-10.

promised goods or services in the contract. The entity provides (or otherwise makes available—for example, makes available for download) a copy of the intellectual property to the customer on December 20, 20X0.

606-10-55-399L

In identifying the goods and services promised to the customer in the contract (in accordance with guidance in paragraphs 606-10-25-14 through 25-18), the entity considers whether the contract grants the customer a single promise, for which an attribute of the promised license is that during Year 1 of the contract the customer is restricted from embedding the intellectual property in the Class 2 consumer products), or two promises (that is, a license for a right to embed the entity's intellectual property in Class 1 for a five-year period beginning on January 1, 20X1, and a right to embed the entity's intellectual property in Class 2 for a four-year period beginning on January 1, 20X2).

606-10-55-399M

In making this assessment, the entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's intellectual property in Class 2 only commences one year after the right for the customer to embed the entity's intellectual property in Class 1 means that after the customer can begin to use and benefit from its right to embed the entity's intellectual property in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed intellectual property (that is, the entity must still fulfill its promise to grant the customer the right to embed the entity's intellectual property in Class 2). The entity does not transfer control of the right to embed the entity's intellectual property in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

606-10-55-399N

The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the other. Therefore, each right is capable of being distinct in accordance with paragraph 606-10-25-19(a)). In addition, the entity concludes that the promise to transfer each license is separately identifiable (that is, each right meets the criterion in paragraph 606-10-25-19(b)) on the basis of an evaluation of the principle and the factors in paragraph 606-10-25-21. The entity concludes that it is not providing any integration service with respect to the two rights (that is, the two rights are not inputs to a combined output with functionality that is different from the functionality provided by the licenses independently), neither right significantly modifies or customizes the other, and the entity can fulfill its promise to transfer each right to the customer independently of the other (that is, the entity could transfer either right to the customer without transferring the other). In addition, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

606-10-55-399O

Because each right is distinct, they constitute separate performance obligations. On the basis of the nature of the licensed intellectual property and the fact that there is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period, each promise to transfer one of the two licenses in this contract provides the customer with a right to use the entity's intellectual property and the entity's promise to transfer each license is, therefore, satisfied at a point in time. The entity determines at what point in time to recognize the revenue allocable to each performance obligation in accordance with paragraphs 606-10-55-58B through 55- 58C. Because a customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

In the Basis for Conclusions of ASU 2016-10,[204] the FASB noted that the license to the symphony recording in Example 59 includes multiple restrictions of time, geography and use (i.e., the license gives the customer the right to use the recording for two years, only in Country A and only in commercials). Those restrictions are attributes of a single promised license because once the customer controls the rights transferred by that license, there is no additional promise for the entity to fulfill (e.g., no promise to transfer control of additional rights to use the intellectual property).

In contrast, the contract in Example 61B provides the customer with the right to embed the licensed intellectual property in its Class 1 products during the first year of the contract but prohibits the customer from embedding the licensed intellectual property in its Class 2 products until the second year. That is, the entity must grant an additional right to the customer in year two to allow the licensed intellectual property to be embedded in the Class 2 products. Accordingly, the entity in this example determined that this provision is not solely an attribute of a single license. Rather, the provision demonstrates that the entity has a remaining promise to fulfill after transferring the initial right to embed the licensed intellectual property in the Class 1 consumer products. That is, because the customer does not control a license until it can begin to use and benefit from the rights transferred, the entity must still fulfill a second promise to transfer control of the right to embed the licensed intellectual property in the Class 2 consumer products (and would wait to recognize revenue for the right to embed the intellectual property in the Class 2 products until that point).

The FASB noted in the Basis for Conclusions[205] that it evaluated a number of contractual provisions besides those included in the standard, including a common contractual provision in the media and entertainment industry called "broken windows." This provision provides for substantial breaks between time periods or windows in a licensing contract during which a customer is able to use (or access) intellectual property. Media and entertainment entities had questioned whether the windows in such an arrangement represent separate licenses, even if the rights in each time period are the same. The Board explained that, while it didn't include a broken windows example in the standard, its view is that a substantive break between the time periods for which a customer has the right to use intellectual property might suggest that the customer's rights have been revoked for that period of time and that the entity has made an additional promise to transfer rights to use that same intellectual property again at a later date.

In many contracts, multiple, distinct rights may be transferred to a customer at the same point in time (e.g., licenses for multiple rights to use intellectual property) or over the same period of time (e.g., licenses for multiple rights to access intellectual property). The Board noted[206] that an entity is not required to separately identify each set of distinct rights if those rights are transferred concurrently. For example, the licensor in Example 61B would not be precluded from accounting for the two sets of distinct rights as a single performance obligation if the facts were modified such that the customer was able to use and benefit from both sets of rights (i.e., Class 1 and Class 2) at the same time during the first year of the contract (rather than Class 1 starting in year one and Class 2 starting only in year two).

How we see it

We believe a critical part of the evaluation of contractual restrictions is whether a restriction requires an entity to *grant additional rights* to the customer at a future date in order to fulfill its promises under the contract. The presence of a requirement to grant additional rights to the customer indicates that there may be multiple performance obligations that need to be accounted for under Step 2 of the model.

An entity may need to apply significant judgment to distinguish between a single promised license with multiple attributes and a license that contains multiple promises to the customer that may be separate performance obligations.

[204] Paragraph BC44 of ASU 2016-10.
[205] Paragraph BC45 of ASU 2016-10.
[206] Paragraph BC47 of ASU 2016-10.

IASB differences

IFRS 15 includes language on contractual restrictions that differs from the language on contractual provisions in ASC 606-10-55-64. However, the IASB noted in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that, consistent with the US GAAP standard, an entity should apply the requirements in Step 2 of the general model on identifying performance obligations when distinguishing between contractual provisions that create promises to transfer additional rights (and therefore may be separate performance obligations) from contractual provisions that are merely attributes of a license that establish when, where and how the right may be used. Under both IFRS 15 and ASC 606, significant judgment will be required to distinguish between a contract that contains a single license with multiple attributes and a contract that contains multiple licenses to the customer that represent separate performance obligations.

8.1.4 Guarantees to defend or maintain a patent

The standard states that a guarantee to defend or maintain a patent does not represent a promised good or service in a licensing contract. This type of guarantee also does not affect whether a license provides a right to access (i.e., symbolic intellectual property and functional intellectual property that meets the criteria in ASC 606-10-55-62(a) and (b)) or a right to use (i.e., functional intellectual property that doesn't meet the criteria in ASC 606-10-55-62(a) and (b)) an entity's intellectual property. This provision is similar to legacy guidance in SAB Topic 13. See Section 8.2.1 and 8.2.2 below for discussion on functional and symbolic licenses of intellectual property.

The guidance on the accounting for guarantees to defend or maintain a patent is included in the following excerpt from the standard:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-64A

Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use do not affect whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

Question 8-1 **How should entities account for modifications to licenses of intellectual property?**

A license provides a customer with rights to use or access the intellectual property of an entity. The terms of each license of intellectual property are defined by the contract, which establishes the customer's rights (e.g., period of time, area of use). We believe that when a contract for a license of intellectual property is modified, the additional and/or modified license of intellectual property is distinct from the original license because the new and/or modified rights will always differ from those conveyed by the original license.

The standard's contract modification guidance (see Section 3.4) requires that a modification in which the additional promised goods or services are distinct be accounted for on a prospective basis as follows:

- The modification will be accounted for as a separate contract if the additional consideration from the modification reflects the new license's standalone selling price in accordance with ASC 606-10-25-12.
- If the additional consideration does not reflect the standalone selling price of the new license, the modification would be accounted for in accordance with 606-10-25-13.

For a modification accounted for as a termination of the original contract and creation of a new contract in accordance with ASC 606-10-25-13(a), any revenue recognized to date under the original contract is not adjusted. At the modification date, the remaining unrecognized transaction price from the original contract (if any) plus the additional transaction price from the new contract is allocated to the remaining performance obligation(s) in the new contract. Any revenue allocated to a performance obligation created at the modification date for the renewal or extension of a license should not be recognized until the beginning of the renewal or extension period (see Section 8.4).

8.2 Determining the nature of the entity's promise in granting a license

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that clarified how an entity will evaluate the nature of a promise to grant a license of intellectual property to determine whether the promise is satisfied (and revenue is recognized) over time or at a point in time. The amendments also require entities to classify intellectual property in one of two categories (i.e., functional or symbolic).

Entities will need to evaluate the nature of a promise to grant a license of intellectual property in order to determine whether the promise is satisfied (and revenue is recognized) over time or at a point in time. Because this evaluation can be difficult, the standard includes the following requirement for entities to classify intellectual property in one of two categories — functional or symbolic:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

Determining the Nature of the Entity's Promise

606-10-55-59

To determine whether the entity's promise to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

a. Functional intellectual property. Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.

b. Symbolic intellectual property. Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

As explained in the Basis for Conclusion of ASU 2016-10,[207] the licenses guidance is premised on the view that an entity's promise (explicit or implicit) to support or maintain intellectual property is inseparable from the entity's promise to grant the license when the activities to support or maintain the intellectual property *significantly* affect the "utility" of the intellectual property (i.e., its ability to provide benefit or value). Supporting or maintaining intellectual property generally includes undertaking activities (that do not transfer a good or service to the customer) that significantly affect the utility of the intellectual property. It could also include *not* undertaking activities or otherwise taking actions that would significantly degrade the utility of the intellectual property.

The FASB noted[208] that whether an entity's promise to a customer includes supporting or maintaining intellectual property largely depends on whether the intellectual property has significant standalone functionality. Intellectual property that has significant standalone functionality is considered functional intellectual property. In contrast, intellectual property that does not have significant standalone functionality is considered symbolic intellectual property because it derives substantially all of its utility from the entity's past or ongoing activities (that do not transfer a good or service to the customer).

IASB differences

IFRS 15 does not require entities to classify licenses of intellectual property as either functional or symbolic. Under IFRS 15.B58, one of the three criteria to classify a license as a right to access (and therefore record revenue over time) is that "the contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights."

The Boards agreed that their approaches generally will result in consistent answers, but there could be differences between US GAAP and IFRS when entities license brand names that no longer have any related ongoing activities (e.g., the license to the brand name of a defunct sports team such as the Brooklyn Dodgers). Under the FASB's approach, a license of a brand name would be classified as symbolic intellectual property, and revenue would be recognized over time, regardless of whether there are any related ongoing activities. Under the IASB's approach, revenue would be recognized at a point in time if there are no ongoing activities that significantly affect the intellectual property.

8.2.1 Functional intellectual property

Functional intellectual property has significant standalone functionality (e.g., the ability to process a transaction, perform a function or task, be played or aired). This type of intellectual property does not require the licensor to continue to support or maintain the intellectual property as part of the promise to the customer. The Basis for Conclusions of ASU 2016-10[209] provides examples of functional intellectual property including software, biological compounds, drug formulas, completed media content (e.g., films, television shows, music) and patents underlying highly functional items (e.g., a patent to a specialized manufacturing process).

Licenses of functional intellectual property grant a right to use the entity's intellectual property and revenue generally will be recognized at the point in time when the intellectual property is made available for the customer's use and benefit (refer to Section 8.3 for further discussion on the timing of revenue recognition for licenses of intellectual property). This will be the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer another good

[207] Paragraphs BC52 and BC55 of ASU 2016-10.

[208] Paragraph BC56 of ASU 2016-10.

[209] Paragraph BC56 of ASU 2016-10.

or service to the customer. As noted in the Basis for Conclusions of ASU 2016-10,[210] an entity's ongoing activities that do not substantively change the standalone functionality of functional intellectual property may affect the utility of the intellectual property but would not *significantly* affect it, so continuing to support or maintain the intellectual property is not part of the promise to a customer in transferring a license to functional intellectual property.

If the functionality of intellectual property is expected to substantively change as a result of activities that do not transfer a good or service to the customer, and the customer would be required or compelled to use the latest version of the intellectual property, the license would grant a right to access the entity's functional intellectual property, and revenue would be recognized over time. However, as discussed below, we expect licenses of functional intellectual property to meet the criteria to be recognized over time infrequently, if at all.

The standard includes the following guidance for determining whether a customer is provided with a right to use or right to access functional intellectual property:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

Determining the Nature of the Entity's Promise

606-10-55-62

A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.

b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

606-10-55-63

Because functional intellectual property has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the intellectual property to which the customer has rights. Therefore, the entity's promise to the customer in granting a license to functional intellectual property does not include supporting or maintaining the intellectual property. Consequently, if a license to functional intellectual property is a separate **performance obligation** (see paragraph 606-10-55-55) and does not meet the criteria in paragraph 606-10-55-62, it is satisfied at a point in time (see paragraphs 606-10-55-58B through 55-58C).

The following example from the standard illustrates an assessment of the nature of a license that is determined to represent functional intellectual property that will be recognized at a point in time (i.e., a right to use license):

[210] Paragraph BC56 of ASU 2016-10.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 54 — Right to Use Intellectual Property

606-10-55-362

Using the same facts as in Case A in Example 11 (see paragraphs 606-10-55-141 through 55-145), the entity identifies four performance obligations in a contract:

a. The software license

b. Installation services

c. Software updates

d. Technical support.

606-10-55-363

The entity assesses the nature of its promise to transfer the software license. The entity first concludes that the software to which the customer obtains rights as a result of the license is functional intellectual property. This is because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

606-10-55-363A

The entity further concludes that while the functionality of the underlying software is expected to change during the license period as a result of the entity's continued development efforts, the functionality of the software to which the customer has rights (that is, the customer's instance of the software) will change only as a result of the entity's promise to provide when-and-if available software updates. Because the entity's promise to provide software updates represents an additional promised service in the contract, the entity's activities to fulfill that promised service are not considered in evaluating the criteria in paragraph 606-10-55-62. The entity further notes that the customer has the right to install, or not install, software updates when they are provided such that the criterion in 606-10-55-62(b) would not be met even if the entity's activities to develop and provide software updates had met the criterion in paragraph 606-10-55-62(a).

606-10-55-363B

Therefore, the entity concludes that it has provided the customer with a right to use its software as it exists at the point in time the license is granted and the entity accounts for the software license performance obligation as a performance obligation satisfied at a point in time. The entity recognizes revenue on the software license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

Generally, revenue for distinct licenses of functional intellectual property will be recognized at a point in time. However, if an entity meets the criteria in ASC 606-10-55-62, revenue for a license of functional intellectual property will be recognized over time because that license would grant rights to access the entity's functional intellectual property. The Board explained in the Basis for Conclusions of ASU 2016-10[211] that it included the guidance in ASC 606-10-55-62 because it would be inconsistent with the principles of the licenses guidance to conclude that an entity's ongoing activities would not significantly affect the utility of functional intellectual property licensed to a customer if those ongoing activities: (1) substantively change the functionality of the intellectual property without transferring an additional good or service to

[211] Paragraph BC58 of ASU 2016-10.

the customer and (2) directly affect the customer because the customer is subject to those changes in functionality. In this situation, the Board decided that an entity is only granting the customer the right to access its intellectual property in its present form, and the entity is required to continue to perform throughout the license period by making the changed intellectual property (e.g., changed code, content, or design) available to the customer.

Although the FASB included the guidance in ASC 606-10-55-62 for its conceptual merits, it noted[212] that it expects entities will meet the criteria to recognize licenses of functional intellectual property over time *infrequently, if at all*. This is because when an entity performs activities to support or update functional intellectual property, the provision of those activities are typically an additional promised service to the customer and will therefore not meet the criteria in ASC 606-10-55-62(a). This is depicted in Example 54 above, in which the entity's activities to develop or provide software updates do not meet the criterion in ASC 606-10-55-62(a) because the updates are determined to be an additional promised service to the customer.

That said, a license to functional intellectual property may end up being recognized over time because it is required to be combined with another good or service in Step 2 of the model, and the appropriate pattern of recognition for the combined performance obligation is over time. In this situation, if an entity determines the combined performance obligation should be recognized over time, that conclusion is based on the characteristics of the license of intellectual property and other goods/services underlying the combined performance obligation, not because the functional intellectual property underlying the license meets the criteria to be recognized over time under the licenses guidance. This concept of assessing a combined performance obligation that includes a license of intellectual property to determine the appropriate pattern of revenue recognition is discussed below in Section 8.2.4.

How we see it

It is important for entities that provide licenses of functional intellectual property to their customers to appropriately identify the promised goods or services in their contracts as part of Step 2 of the model because those conclusions may directly affect their evaluation of the criterion in ASC 606-10-55-62(a). Because functional intellectual property, by definition, has standalone functionality (e.g., the ability to process a transaction, perform a function or task, be played or aired), we would expect an entity that upon initial evaluation believes it meets the criteria in ASC 606-10-55-62 to reaffirm that the promised goods or services identified in its Step 2 analysis is appropriate. Like the FASB, we expect distinct licenses of functional intellectual property to be recognized over time infrequently, if at all.

8.2.2 Symbolic intellectual property

Symbolic intellectual property is any intellectual property that is not functional intellectual property. In other words, symbolic intellectual property does not have significant standalone functionality. The utility of symbolic intellectual property is largely derived from a licensor's ongoing or past support that does not transfer a promised good or service to a customer (e.g., activities that support the value of character images licensed from an animated film). The Basis for Conclusions of ASU 2016-10[213] provides examples of symbolic intellectual property including brands, team or trade names, logos and franchise rights.

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[212] Paragraph BC58 of ASU 2016-10.

[213] Paragraph BC57 of ASU 2016-10.

Licenses of symbolic intellectual property grant a right to access an entity's intellectual property for which revenue will be recognized over time as the performance obligation is satisfied (e.g., over the license period). This is described in the standard as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Determining the Nature of the Entity's Promise

606-10-55-60

A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs 606-10-55-58A and 606-10-55-58C) as the entity fulfills its promise to both:

a. Grant the customer rights to use and benefit from the entity's intellectual property

b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

The Basis for Conclusions of ASU 2016-10[214] explains that the absence of significant standalone functionality for symbolic intellectual property means that the utility of the intellectual property depends on the entity supporting or maintaining it. For example, a license to a sports team's name and logo typically will have limited residual value if the team stops playing games. Therefore, in granting a license of symbolic intellectual property, the entity's promise to a customer is both to: (1) grant the customer rights to use and benefit from the intellectual property, which includes making a copy of the underlying intellectual property available for the customer's use and (2) support or maintain the intellectual property for a period of time.

When determining the period of time over which a performance obligation to grant a license of symbolic intellectual property is satisfied, the entity's obligation to support or maintain the intellectual property exists for the duration of the license period, unless the license period is longer than the remaining economic life of the intellectual property. The FASB noted[215] that it is reasonable to assume that an entity will not support or maintain intellectual property past the end of the intellectual property's economic life.

The standard includes the following example to illustrate an assessment of the nature of a license that is determined to represent symbolic intellectual property:

[214] Paragraph BC57 of ASU 2016-10.

[215] Paragraph BC57 of ASU 2016-10.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 58 — Access to Intellectual Property

606-10-55-383

An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. There are main characters involved in each of the comic strips. However, newly created characters appear and disappear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in shows or parades, within reasonable guidelines.

606-10-55-384

In exchange for granting the license, the entity receives a fixed payment of $1 million in each year of the 4-year term.

606-10-55-385

The entity concludes that it has made no other promises to the customer other than the promise to grant a license. That is, the additional activities associated with the license do not directly transfer a good or service to the customer. Therefore, the entity concludes that its only performance obligation is to transfer the license.

606-10-55-386

The entity assesses the nature of its promise to transfer the license and concludes that the nature of its promise is to grant the customer the right to access the entity's symbolic intellectual property. The entity determines that the licensed intellectual property (that is, the character names and images) is symbolic because it has no standalone functionality (the names and images cannot process a transaction, perform a function or task, or be played or aired separate from significant additional production that would, for example, use the images to create a movie or a show) and the utility of those names and images is derived from the entity's past and ongoing activities such as producing the weekly comic strip that includes the characters.

606-10-55-387

Because the nature of the entity's promise in granting the license is to provide the customer with a right to access the entity's intellectual property, in accordance with paragraph 606-10-55- 58A, the entity accounts for the promised license as a performance obligation satisfied over time.

606-10-55-388

The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. The entity considers paragraphs 606-10-25-31 through 25-37 in identifying the method that best depicts its performance in the license. Because the contract provides the customer with unlimited use of the licensed characters for a fixed term, the entity determines that a time-based method would be the most appropriate measure of progress toward complete satisfaction of the performance obligation.

Question 8-2 **Can revenue for a license of symbolic intellectual property be recognized at a point in time if the licensor does not expect to perform or provide any activities to support or maintain the intellectual property?**

No. Licenses for symbolic intellectual property will always represent a right to access an entity's intellectual property and, therefore, revenue for these types of licenses will be recognized over time.

As noted in the Basis for Conclusions of ASU 2016-10,[216] the FASB discussed but decided not to include an override to the guidance that all licenses of symbolic intellectual property are satisfied over time. In making this decision, the Board noted that (1) the number of licensing arrangements for which symbolic intellectual property would have been recognized at a point in time is small because most licensors continue to be involved with their symbolic intellectual property throughout its economic life and (2) requiring over-time recognition of revenue for licenses of symbolic intellectual property improves the operability and understandability of the licenses guidance. Further, the Board concluded that the clarity and simplicity of this requirement outweighed the conceptual rationale for an override for licenses of symbolic intellectual property.

8.2.3 Evaluating functional versus symbolic intellectual property

The standard includes a flowchart to assist an entity with determining the nature of its promise in granting a license of intellectual property:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

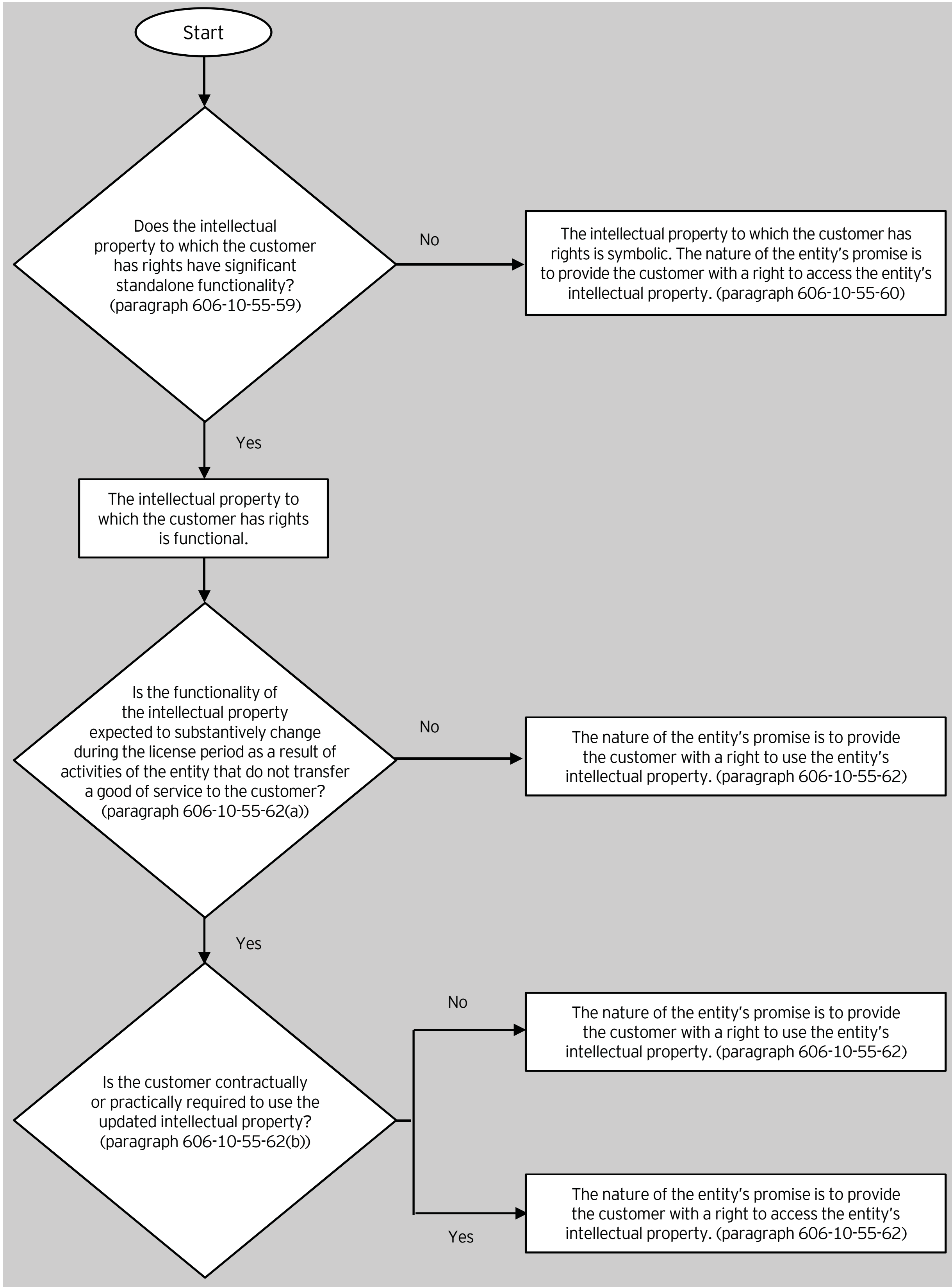
Implementation Guidance and Illustrations

Determining the Nature of the Entity's Promise

606-10-55-63A

The following flowchart depicts the decision process for evaluating whether the nature of an entity's promise in granting a license is to provide the customer with a right to access the entity's intellectual property or a right to use the entity's intellectual property. The flowchart does not include all of the guidance on determining the nature of an entity's promise in granting a license of intellectual property in this Subtopic and is not intended as a substitute for the guidance in this Subtopic.

[216] Paragraphs BC63 and BC65 of ASU 2016-10.


Start
Does the intellectual property to which the customer has rights have significant standalone functionality? (paragraph 606-10-55-59)
No
The intellectual property to which the customer has rights is symbolic. The nature of the entity's promise is to provide the customer with a right to access the entity's intellectual property. (paragraph 606-10-55-60)
Yes
The intellectual property to which the customer has rights is functional.
Is the functionality of the intellectual property expected to substantively change during the license period as a result of activities of the entity that do not transfer a good of service to the customer? (paragraph 606-10-55-62(a))
No
The nature of the entity's promise is to provide the customer with a right to use the entity's intellectual property. (paragraph 606-10-55-62)
Yes
Is the customer contractually or practically required to use the updated intellectual property? (paragraph 606-10-55-62(b))
No
The nature of the entity's promise is to provide the customer with a right to use the entity's intellectual property. (paragraph 606-10-55-62)
Yes
The nature of the entity's promise is to provide the customer with a right to access the entity's intellectual property. (paragraph 606-10-55-62)

8.2.4 Applying the licenses guidance to a bundled performance obligation that includes a license of intellectual property

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that clarified that an entity will need to consider the licenses guidance for a bundled performance obligation that is comprised of a license of intellectual property and other goods or services to help determine the nature of its promise and how it will recognize revenue for the combined performance obligation.

To the extent that an entity is required to bundle a license of intellectual property with other promised goods and services in a contract, it will need to consider the licenses guidance to help determine the nature of its promise to the customer as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-57

When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and, if over time, in selecting an appropriate method for measuring progress in accordance with paragraphs 606-10-25-31 through 25-37.

As stated above in the standard, entities will need to consider the licenses guidance when (1) determining whether the overall promise is satisfied over time or at a point in time and (2) selecting an appropriate method for measuring progress of that performance obligation if it is satisfied over time. Considering the nature of an entity's promise in granting a license that is part of a combined performance obligation is not a separate step or evaluation in the revenue model. Rather, it is part of the overall requirement in Step 5 to determine the nature of a combined performance obligation in order to determine whether that performance obligation is satisfied over time or at a point in time and measure progress toward the satisfaction of the combined performance obligation if it is satisfied over time.

The Board explained in the Basis for Conclusions of ASU 2016-10[217] that, in some instances, not considering the nature of the entity's promise in granting a license that is bundled with other promised goods or services in the contract would result in accounting that does not best reflect the entity's performance. For example, it would be inappropriate for an entity that grants a 10-year license to access the entity's intellectual property that is not distinct from a promise to provide a one-year service to conclude that the bundled performance obligation is satisfied over the one-year service period. This is because the promise to grant the license would have been satisfied over the 10-year license term if it had been a separate performance obligation.

[217] Paragraph BC66 of ASU 2016-10.

The standard includes a number of examples that illustrate how an entity applies the licenses guidance to help determine the nature of a combined performance obligation that includes a license of intellectual property and other promised goods or services.

In Example 56, Case A (excerpted below), an entity licenses the patent rights for an approved drug compound to its customer and also promises to manufacture the drug for the customer. The entity considers that no other entity can perform the manufacturing service because of the highly specialized nature of the manufacturing process. Therefore, the license cannot be purchased separately from the manufacturing service, and the customer cannot benefit from the license on its own or with other readily available resources (i.e., the license and the manufacturing service are not capable of being distinct). Accordingly, the entity's promises to grant the license and to manufacture the drug are accounted for as a single performance obligation satisfied over time as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 56 — Identifying a Distinct License

606-10-55-367

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer for 5 years, while the customer develops its own manufacturing capability. The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical composition). There are no other promised goods or services in the contract.

Case A — License is Not Distinct

606-10-55-368

In this case, no other entity can manufacture this drug while the customer learns the manufacturing process and builds its own manufacturing capability because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing service.

606-10-55-369

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer cannot benefit from the license without the manufacturing service; therefore, the criterion in paragraph 606-10-25-19(a) is not met. Consequently, the license and the manufacturing service are not distinct, and the entity accounts for the license and the manufacturing service as a single performance obligation.

606-10-55-370

The nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years; the customer benefits from the license only as a result of having access to a supply of the drug. After the first five years, the customer retains solely the right to use the entity's functional intellectual property (see Case B, paragraph 606-10-55-373), and no further performance is required of the entity during Years 6–10. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation (that is, the bundle of the license and the manufacturing service) is a performance obligation satisfied at a point in time or over time. Regardless of the determination reached in accordance with paragraphs 606-10-25-23 through 25-30, the entity's performance under the contract will be complete at the end of Year 5.

This example (Example 56, Case A) illustrates the importance of applying the licenses guidance when determining the nature of an entity's promise in granting a license that is combined into a single performance obligation with other promised goods or services. That is because the conclusion of whether a non-distinct license provides the customer with a right to use intellectual property or a right to access intellectual property may have a significant effect on the timing of revenue recognition for a combined performance obligation. The FASB explains in the Basis for Conclusions of ASU 2016-10[218] that in this example, the entity needs to determine the nature of its promise in granting the license within the single license/manufacturing service performance obligation to appropriately apply the general principle of recognizing revenue when (or as) it satisfies its performance obligation to the customer. Because the license in this example provides a right to use the entity's intellectual property (i.e., the drug patent is functional intellectual property) that on its own would be recognized at the point in time in which control of the license is transferred to the customer, the combined performance obligation is fully satisfied at the end of the fifth year when the manufacturing service is complete. In contrast, if the license provided a right to access the entity's intellectual property, the combined performance obligation would not be fully satisfied until the end of the 10-year license period, which would likely extend the period of revenue recognition beyond the date when the manufacturing service is complete.

IASB differences

IFRS 15 does not explicitly state that an entity will need to consider the nature of its promise in granting a license when applying the general revenue recognition model to all combined performance obligations that include a license and other goods or services. However, the Basis for Conclusions on IFRS 15 says that an entity considers the nature of its promise in granting the license if the license is the primary or dominant component (i.e., the predominant item) of a single performance obligation. Accordingly, when the license is not the predominant item of a single performance obligation, this may result in US GAAP entities considering the nature of their promises in granting a license more frequently than IFRS entities.

8.3 Transfer of control of licensed intellectual property

When determining whether a license of intellectual property transfers to a customer (and revenue is recognized) over time or at a point in time, the standard states that an entity provides a customer with either:

- A right to access the entity's intellectual property throughout the license period (i.e., symbolic intellectual property and functional intellectual property that meets the criteria in ASC 606-10-55-62(a) and (b)) for which revenue is recognized over the license period
- A right to use the entity's intellectual property as it exists at the point in time the license is granted (i.e., functional intellectual property that doesn't meet the criteria in ASC 606-10-55-62(a) and (b)) for which revenue is recognized at the point in time the customer can first use and benefit from the licensed intellectual property

[218] Paragraph BC68(b) of ASU 2016-10.

The standard provides the following guidance on the timing of revenue recognition for right-to-access and right-to-use licenses:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

606-10-55-58

In evaluating whether a license transfers to a customer at a point in time or over time, an entity should consider whether the nature of the entity's promise in granting the license to a customer is to provide the customer with either:

a. A right to access the entity's intellectual property throughout the license period (or its remaining economic life, if shorter)

b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

606-10-55-58A

An entity should account for a promise to provide a customer with a right to access the entity's intellectual property as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 606-10-25-27(a)). An entity should apply paragraphs 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

606-10-55-58B

An entity's promise to provide a customer with the right to use its intellectual property is satisfied at a point in time. The entity should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer.

606-10-55-58C

Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.

b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

8.3.1 Right to access

The Board concluded that a license that provides an entity with the right to access intellectual property is satisfied over time because the customer simultaneously receives and consumes the benefit from the entity's performance of providing access and the related activities undertaken by the entity. This conclusion is based on the determination that when a license of intellectual property is subject to change, and the customer is exposed to the positive or negative effects of that change, the customer is not able to fully gain control over the license of intellectual property at any given point in time and instead gains control over the license period. Symbolic intellectual property and functional intellectual property that meet the criteria in ASC 606-10-55-62(a) and (b) both provide a customer with a right-to-access license that is satisfied over time. Entities will need to apply the general guidance in ASC 606-10-25-31 through 25-37 to determine the appropriate method to measure progress (see Section 7.1.4).

Step 2 of the model requires an entity to identify the performance obligations in a contract. This includes identifying whether multiple distinct goods or services should be accounted for as a single performance obligation under the series provision (see Section 4.2.2). The FASB noted in the Basis for Conclusions of ASU 2016-10[219] that many licenses that provide a right to access intellectual property may include a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (e.g., a series of distinct periods of access to intellectual property such as monthly access or quarterly access). If a license meets the criteria to be accounted for as a series of distinct goods or services, an entity will need to consider whether any variable consideration in the contract (e.g., royalties, milestone payments) should be allocated to the distinct periods of access if certain allocation criteria are met. See Section 6.3 for a discussion of the variable consideration allocation criteria and Section 8.5 for a discussion of the accounting for sales- or usage-based royalties.

8.3.2 Right to use

The Board concluded that for a license that represents a right to use the intellectual property as it exists at a specific point in time, the customer gains control over that intellectual property at the beginning of the period for which it has the right to use the intellectual property. Functional intellectual property that doesn't meet the criteria in ASC 606-10-55-62(a) and (b) provides a customer with a right to use license that is satisfied at a point in time.

8.3.3 Use and benefit requirement

ASC 606-10-55-58C states that revenue from a license of intellectual property may not be recognized before the customer has (1) access to the intellectual property and (2) the right to use and benefit from the intellectual property. The FASB explained in the Basis for Conclusions of ASU 2014-09[220] that control of a license cannot transfer before the beginning of the period that the customer can use and benefit from the licensed property. As explained in ASC 606-10-55-58C(b), an entity would not recognize revenue before the beginning of the license period, even if it previously provides (or otherwise makes available) a copy of the intellectual property or the customer has a copy of the intellectual property from another transaction. Therefore, if an entity executes a contract and makes the intellectual property available to a customer prior to the start of the license period, it would have to wait to recognize revenue until it completes performance by granting to the customer the right to use and benefit from the license on the start date of the license period.

Consider an example where an entity provides a customer with a right to use intellectual property but indicates that the right to use does not start until 30 days after the agreement is finalized. In this example, the entity likely would conclude that control of the license does not transfer until 30 days after the agreement is finalized because that is when the customer has both access and the right to use and benefit from the intellectual property.

[219] Paragraph BC72 of ASU 2016-10.
[220] Paragraph BC414 of ASU 2014-09.

8.4 License renewals

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that clarified that revenue related to license renewals should not be recognized earlier than the beginning of the renewal period.

In accordance with ASC 606-10-55-58C, revenue related to the renewal of a license of intellectual property may not be recognized prior to the beginning of the renewal period. The FASB explained in the Basis for Conclusions of ASU 2016-10[221] that when two parties enter into a contract to renew (or extend the term of) a license, the renewal contract should not be combined with the original license contract unless the criteria in ASC 606-10-25-9 for combining contracts are met. Therefore, the additional right granted by a renewal (e.g., the right to use the intellectual property for three additional years) should be evaluated in the same manner as any other additional rights that are granted to the customer after the initial contract. That is, the Board determined that a renewal license is subject to the same revenue recognition requirements as any other license that grants rights to the customer, and an entity should not recognize revenue from the transfer of a license before the customer can begin to use and benefit from it. A customer typically can begin to use and benefit from a renewed license only at the beginning of the license renewal period. This is true even if the entity provides a copy of the intellectual property in advance of the renewal period or the customer has a copy of the intellectual property from another transaction.

Example 59 in the standard illustrates when to recognize revenue for a right to use license of functional intellectual property and a subsequent renewal of the license:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 59 — Right to Use Intellectual Property

Case A — Initial License

606-10-55-389

An entity, a music record label, licenses to a customer a recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for two years in Country A starting on January 1, 20X1. In exchange for providing the license, the entity receives fixed consideration of $10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is noncancellable.

606-10-55-390

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that its only performance obligation is to grant the license. The term of the license (two years), the geographical scope of the license (that is, the customer's right to use the symphony only in Country A), and the defined permitted uses for the recording (that is, use in commercials) are all attributes of the promised license in this contract.

[221] Paragraph BC50(a) of ASU 2016-10.

606-10-55-391

In determining that the promised license provides the customer with a right to use its intellectual property as it exists at the point in time at which the license is granted, the entity considers the following:

a. The classical symphony recording has significant standalone functionality because the recording can be played in its present, completed form without the entity's further involvement. The customer can derive substantial benefit from that functionality regardless of the entity's further activities or actions. Therefore, the nature of the licensed intellectual property is functional.

b. The contract does not require, and the customer does not reasonably expect, that the entity will undertake activities to change the licensed recording.

Therefore, the criteria in paragraph 606-10-55-62 are not met.

606-10-55-392

In accordance with paragraph 606-10-55-58B, the promised license, which provides the customer with a right to use the entity's intellectual property, is a performance obligation satisfied at a point in time. The entity recognizes revenue from the satisfaction of that performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Additionally, because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

Case B — Renewal of the License

606-10-55-392A

At the end of the first year of the license period, on December 31, 20X1, the entity and the customer agree to renew the license to the recorded symphony for two additional years, subject to the same terms and conditions as the original license. The entity will continue to receive fixed consideration of $10,000 per month during the 2-year renewal period.

606-10-55-392B

The entity considers the contract combination guidance in paragraph 606-10-25-9 and assesses that the renewal was not entered into at or near the same time as the original license and, therefore, is not combined with the initial contract. The entity evaluates whether the renewal should be treated as a new license or the modification of an existing license. Assume that in this scenario, the renewal is distinct. If the price for the renewal reflects its standalone selling price, the entity will, in accordance with paragraph 606-10-25-12, account for the renewal as a separate contract with the customer. Alternatively, if the price for the renewal does not reflect the standalone selling price of the renewal, the entity will account for the renewal as a modification of the original license contract.

606-10-55-392C

In determining when to recognize revenue attributable to the license renewal, the entity considers the guidance in paragraph 606-10-55-58C and determines that the customer cannot use and benefit from the license before the beginning of the two-year renewal period on January 1, 20X3. Therefore, revenue for the renewal cannot be recognized before that date.

606-10-55-392D

Consistent with Case A, because the customer's additional monthly payments for the modification to the license will be made over two years from the date the customer obtains control of the second license, the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

IASB differences

IFRS 15 does not state that an entity cannot recognize revenue relating to a license renewal until the beginning of the license renewal period. Accordingly, the IASB noted in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that it is possible that IFRS entities will recognize revenue for contract renewals or extensions earlier than US GAAP entities.

8.5 Sales- or usage-based royalties on licenses of intellectual property

FASB amendments

In April 2016, the FASB issued ASU 2016-10 that clarified that the sales- and usage-based royalty exception (i.e., the royalty recognition constraint) must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of intellectual property. It also clarified that the sales- or usage-based royalty in these types of contracts will be either entirely in the scope of royalty recognition constraint guidance or entirely in the scope of the general variable consideration constraint guidance.

The standard provides the following guidance on the recognition of revenue for sales- or usage-based royalties on licenses of intellectual property that differs from the guidance that applies to other revenue from licenses:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Licensing

Sales-Based or Usage-Based Royalties

606-10-55-65

Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize **revenue** for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The **performance obligation** to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

606-10-55-65A

The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

606-10-55-65B

When the guidance in paragraph 606-10-55-65A is met, revenue from a sales-based or usage-based royalty should be recognized wholly in accordance with the guidance in paragraph 606-10-55-65. When the guidance in paragraph 606-10-55-65A is not met, the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14 applies to the sales-based or usage-based royalty.

ASC 606-10-55-65 says that royalties received in exchange for licenses of intellectual property are recognized at the later of when (1) the subsequent sale or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (in whole or in part). That is, an entity recognizes the royalties as revenue when (or as) the customer's subsequent sales or usage occurs, unless that recognition pattern accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely or partially relates based on an appropriate measure of progress (see Section 7.1.4).

The Board explained in the Basis for Conclusions of ASU 2016-10[222] that for a license of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize any revenue for the variable amounts until the uncertainty is resolved (i.e., when a customer's subsequent sales or usage occurs).

The FASB also explained in the Basis for Conclusions of ASU 2016-10[223] that the guidance in ASC 606-10-55-65 through 55-65B addresses the *recognition* of sales-based or usage-based royalties received in exchange for a license of intellectual property, rather than when such amounts are included in the transaction price of the contract. As a result, this exception is a recognition constraint, and the constraint on variable consideration (see Section 5.2.3) does not apply.

The Board said[224] it added the royalty recognition constraint because both users and preparers of financial statements indicated that it would not be useful for entities to recognize a constrained amount of revenue for sales- or usage-based royalties received in exchange for licenses of intellectual property (following the guidance in the general model on estimating the transaction price) because those revenue amounts would be subject to frequent adjustments throughout the life of the contract as a result of changes in circumstances that are not related to the entity's performance. The Board observed that this would not result in relevant information, especially for contracts in which the sales- or usage-based royalties are paid over a long period of time.

ASC 606-10-55-65A requires that the royalty recognition constraint be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of intellectual property (including when no single license is the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licenses in the contract[225]). The standard does not provide a bright line for determining the "predominant" item in a contract that includes a license of intellectual property. The Board acknowledged in the Basis for Conclusions of ASU 2016-10[226] that significant judgment may be required to determine when a license is the predominant item to which a royalty relates. However, it said that applying the general variable consideration guidance to such contracts would likely be more complex and require more judgment than determining whether a license is the predominant item.

It is important to note that this guidance applies only to licenses of intellectual property for which some or all of the consideration is in the form of a sales- or usage-based royalty. Entities cannot analogize to it for other situations. For example, if consideration in a contract is in the form of a sales- or usage-based royalty but there is no license of intellectual property, this guidance would not apply. In such cases, an entity would follow the guidance in the general model on estimating variable consideration and applying the constraint on variable consideration (see Section 5.2).

[222] Paragraph BC70 of ASU 2016-10.
[223] Paragraph BC71 of ASU 2016-10.
[224] Paragraph BC73 of ASU 2016-10.
[225] Paragraph BC75(b) of ASU 2016-10.
[226] Paragraph BC77 of ASU 2016-10.

The standard provides the following example of a contract that includes two performance obligations, including a license of symbolic intellectual property, and consideration in the form of sales-based royalties. In the example, the license is determined to be the predominant item to which the royalty relates:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 60 — Sales-Based Royalty Promised in Exchange for a License of Intellectual Property and Other Goods and Services

606-10-55-393

An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week airing period and to sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week airing period. In exchange for providing the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (that is, variable consideration in the form of a sales-based royalty).

606-10-55-394

The entity concludes that the license to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the related promotional goods or services. The entity will recognize revenue from the sales-based royalty, the only fees to which the entity is entitled under the contract, wholly in accordance with paragraph 606-10-55-65. If the license, the memorabilia, and the advertising activities were separate performance obligations, the entity would allocate the sales-based royalties to each performance obligation.

As illustrated in this example, ASC 606-10-55-65B requires that when the royalty recognition constraint is applied, the royalty stream should be accounted for either entirely under the royalty constraint guidance or entirely under the general variable consideration constraint guidance (see Section 5.2.3). That is, an entity should not split a single royalty and apply the royalty recognition constraint to a portion of it and the general variable consideration constraint to the other portion. The Board concluded in the Basis for Conclusions of ASU 2016-10[227] that accounting for a single royalty in accordance with two different constraint models (i.e., splitting a royalty) would have been more complex for preparers while not providing more useful information for financial statement users. This is because using an approach that accounts for a single royalty using two different constraint models would result in amounts being recognized at contract inception that do not reflect the amount to which the entity expects to be entitled to for its performance or amounts that the entity has become legally entitled to during the period.

Regardless of whether an entity applies the royalty recognition constraint or the general constraint on variable consideration, it is still required to allocate sales- or usage-based royalties to separate performance obligations in a contract (as noted in Example 60 above). The following example from the standard also illustrates the allocation of the transaction price (including sales- or usage-based royalties) to the performance obligations in the contract:

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[227] Paragraph BC76 of ASU 2016-10.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 35 — Allocation of Variable Consideration

606-10-55-270

An entity enters into a contract with a customer for two intellectual property licenses (Licenses X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The standalone selling prices of Licenses X and Y are $800 and $1,000, respectively.

Case A — Variable Consideration Allocated Entirely to One Performance Obligation

606-10-55-271

The price stated in the contract for License X is a fixed amount of $800, and for License Y the consideration is 3 percent of the customer's future sales of products that use License Y. For purposes of allocation, the entity estimates its sales-based royalties (that is, the variable consideration) to be $1,000, in accordance with paragraph 606-10-32-8.

606-10-55-272

To allocate the transaction price, the entity considers the criteria in paragraph 606-10-32-40 and concludes that the variable consideration (that is, the sales-based royalties) should be allocated entirely to License Y. The entity concludes that the criteria in paragraph 606-10-32-40 are met for the following reasons:

a. The variable payment relates specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y).

b. Allocating the expected royalty amounts of $1,000 entirely to License Y is consistent with the allocation objective in paragraph 606-10-32-28. This is because the entity's estimate of the amount of sales-based royalties ($1,000) approximates the standalone selling price of License Y and the fixed amount of $800 approximates the standalone selling price of License X. The entity allocates $800 to License X in accordance with paragraph 606-10-32-41. This is because, based on an assessment of the facts and circumstances relating to both licenses, allocating to License Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 606-10-32-28.

606-10-55-273

The entity transfers License Y at inception of the contract and transfers License X one month later. Upon the transfer of License Y, the entity does not recognize revenue because the consideration allocated to License Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph 606-10-55-65, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

606-10-55-274

When License X is transferred, the entity recognizes as revenue the $800 allocated to License X.

Case B — Variable Consideration Allocated On the Basis of Standalone Selling Prices

606-10-55-275

The price stated in the contract for License X is a fixed amount of $300, and for License Y the consideration is 5 percent of the customer's future sales of products that use License Y. The entity's estimate of the sales-based royalties (that is, the variable consideration) is $1,500 in accordance with paragraph 606-10-32-8.

606-10-55-276

To allocate the transaction price, the entity applies the criteria in paragraph 606-10-32-40 to determine whether to allocate the variable consideration (that is, the sales-based royalties) entirely to License Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y), allocating the variable consideration entirely to License Y would be inconsistent with the principle for allocating the transaction price. Allocating $300 to License X and $1,500 to License Y does not reflect a reasonable allocation of the transaction price on the basis of the standalone selling prices of Licenses X and Y of $800 and $1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 606-10-32-31 through 32-35.

606-10-55-277

The entity allocates the transaction price of $300 to Licenses X and Y on the basis of relative standalone selling prices of $800 and $1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative standalone selling price basis. However, in accordance with paragraph 606-10-55-65, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

606-10-55-278

License Y is transferred to the customer at the inception of the contract, and License X is transferred three months later. When License Y is transferred, the entity recognizes as revenue the $167 ($1,000 ÷ $1,800 × $300) allocated to License Y. When License X is transferred, the entity recognizes as revenue the $133 ($800 ÷ $1,800 × $300) allocated to License X.

606-10-55-279

In the first month, the royalty due from the customer's first month of sales is $200. Consequently, in accordance with paragraph 606-10-55-65, the entity recognizes as revenue the $111 ($1,000 ÷ $1,800 × $200) allocated to License Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the $89 ($800 ÷ $1,800 × $200) allocated to License X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

Recognition of royalties for a license that provides a right to access intellectual property

The FASB explained in the Basis for Conclusions of ASU 2016-10[228] that the royalty recognition constraint is intended to align the recognition of the royalties with the standard's key principle that revenue should be recognized only when (or as) an entity satisfies a performance obligation. As discussed above, ASC 606-10-55-65 says that sales- or usage-based royalties received in exchange for licenses of intellectual property are recognized at the later of when (a) the subsequent sale or usage occurs or (b) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (in whole or in part). That is, an entity recognizes revenue for such arrangements when (or as) the customer's subsequent sales or usage occurs, unless that recognition pattern accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely or partially relates based on an appropriate measure of progress (see Section 7.1.4).

[228] Paragraph BC71 of ASU 2016-10.

The Board provided the following example[229] of when revenue recognition may be inappropriately accelerated ahead of an entity's performance if revenue was recognized under ASC 606-10-55-65(a) for a right-to-access license:

Example of a licensing contract with a declining royalty rate

A contract provides a customer with the right to access an entity's intellectual property, and the entity receives royalties of 8% on total sales up to $1 million, 4% on the next $3 million in sales and 2% on all sales above $4 million. The declining royalty rate does not reflect changing value to the customer.

In this example, the FASB noted that recognizing royalties as they are due (i.e., according to the contractual formula) would not be aligned with the principle of recognizing revenue only when (or as) an entity satisfies a performance obligation because the right to access the intellectual property is provided evenly over the license term while the declining royalty rate does not reflect the value to the customer. However, the FASB stated that the existence of a declining royalty rate in a contract does not always mean that recognizing revenue for sales- or usage-based royalties as the customer's underlying sales or usage occurs is inappropriate. In fact, it would be appropriate if the declining royalty rate reflects the changing value to the customer.

The above example notwithstanding, for many contracts with licenses that provide a right to access an entity's intellectual property, applying the royalty recognition constraint guidance will result in an entity recognizing revenue from sales- or usage-based royalties as the customer's underlying sales or usage occurs in accordance with ASC 606-10-55-65(a). As described in the Basis for Conclusions of ASU 2016-10,[230] this is because an output-based measure of progress that is the same as, or similar to, the application of the practical expedient in ASC 606-10-55-18 (that is, when the right to consideration corresponds directly with the value to the customer of the entity's performance to date) will be appropriate because the entity's right to consideration (i.e., the sales- or usage-based royalties earned) will often correspond directly with the value to the customer of the entity's performance completed to date. The practical expedient in ASC 606-10-55-18 is discussed further in Section 7.1.4.

An example of a contract for which an entity may be able to apply the practical expedient in ASC 606-10-55-18 is one in which it earns $1 in royalties for each $10 in revenue that the customer generates from using the licensed intellectual property.

In addition, the Board explained[231] that an output-based measure could also be appropriate for a license that provides a right to access intellectual property in which the consideration is in the form of a fixed fee and royalties. The following example from the standard illustrates this:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 61 — Access to Intellectual Property

606-10-55-395

An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs, and towels for one year. In exchange for providing the license, the entity will receive fixed consideration of $2 million and a royalty of 5 percent of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

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[229] Paragraph BC71 of ASU 2016-10.

[230] Paragraph BC72 of ASU 2016-10.

[231] Paragraph BC72 of ASU 2016-10.

606-10-55-396

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that the only good or service promised to the customer in the contract is the license. The additional activities associated with the license (that is, continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer. Therefore, there is one performance obligation in the contract.

606-10-55-397

To determine whether the entity's promise in granting the license provides the customer with a right to access the entity's intellectual property or a right to use the entity's intellectual property, the entity assesses the nature of the intellectual property to which the customer obtains rights. The entity concludes that the intellectual property to which the customer obtains rights is symbolic intellectual property. The utility of the team name and logo to the customer is derived from the entity's past and ongoing activities of playing games and providing a competitive team (that is, those activities effectively give value to the intellectual property). Absent those activities, the team name and logo would have little or no utility to the customer because they have no standalone functionality (that is, no ability to perform or fulfill a task separate from their role as symbols of the entity's past and ongoing activities).

606-10-55-398

Consequently, the entity's promise in granting the license provides the customer with the right to access the entity's intellectual property throughout the license period and, in accordance with paragraph 606-10-55-58A, the entity accounts for the promised license as a performance obligation satisfied over time.

606-10-55-399

The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license. For the consideration that is in the form of a sales-based royalty, paragraph 606-10-55-65 applies because the sales-based royalty relates solely to the license that is the only performance obligation in the contract. The entity concludes that recognizing revenue from the sales-based royalty when the customer's subsequent sales of items using the team name or logo occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed consideration of $2 million plus recognition of the royalty fees as the customer's subsequent sales occur reasonably depict the entity's progress toward complete satisfaction of the license performance obligation.

In Example 61 above, the fixed consideration of $2 million is an explicit term in the contract with the customer. In some contracts, fixed consideration may be implied, such as when a guaranteed minimum amount of royalties is part of the transaction price.

In addition, as discussed in Section 8.3.1, the FASB noted[232] that many licenses that provide a right to access intellectual property may constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (e.g., a series of distinct periods of access to intellectual property such as monthly access or quarterly access). In cases where the criteria for a performance obligation to be accounted for as a series of distinct goods or services have been met, an entity will need to consider whether any variable consideration in the contract (e.g., sales- or usage-

[232] Paragraph BC72 of ASU 2016-10.

based royalties) should be allocated directly to the distinct periods of access if certain allocation criteria are met. The FASB also noted that the allocation of sales- or usage-based royalties in this manner generally will result in the recognition of royalties as revenue when (or as) the customer's underlying sales or usage occurs.

An entity may need to apply significant judgment to determine the appropriate pattern of revenue recognition for royalties received for a license that provides a right to access intellectual property.

Question 8-3 **Can the recognition constraint for sales- or usage-based royalties be applied to royalties that are paid in consideration for *sales* of intellectual property (rather than just licenses of intellectual property)?**

No. As noted in the Basis for Conclusions of ASU 2016-10,[233] the Board discussed but decided not to expand the scope of the royalty recognition constraint to include sales of intellectual property.

The Board also concluded that entities should not attempt to determine whether a license of intellectual property is "in-substance" a sale of intellectual property (i.e., a promise that is in the form of a license but in substance has the characteristics of a sale) when determining whether the royalty recognition constraint applies. The Board noted that there can be legal differences between a contract for a license and a sale of intellectual property that may not be appropriate or feasible to ignore or attempt to override from an accounting perspective. Therefore, entities should follow the legal form of a license of intellectual property for purposes of applying the royalty recognition constraint.

Question 8-4 **If a contract for a license of intellectual property includes payments with fixed dollar amounts (e.g., milestone payments) that are determined by reference to sales- or usage-based thresholds, should the royalty recognition constraint be applied?**

Yes, we generally believe the royalty recognition constraint should be applied to fixed dollar amounts of variable consideration (i.e., fixed amounts of consideration that are contingent on the occurrence of a future event), such as milestone payments, provided the amounts are determined by reference to sales- or usage-based thresholds. This is the case even if those payments are not referred to as "royalties" under the terms of the contract. However, entities will need to apply judgment and carefully evaluate the facts and circumstances of their contracts for licenses of intellectual property to determine whether these types of payments should be accounted for using the royalty recognition constraint.

Consider the following example:

Illustration 8-1: Application of the royalty recognition constraint to a milestone payment

A vendor enters into a contract to license functional intellectual property to a customer. The contract contains payment terms that include a $10 million milestone payment that is payable to the vendor once the customer has reached $100 million of sales.

The vendor determines that the milestone payment is based on the customer's subsequent sales and represents variable consideration because it is contingent on the customer's sales reaching $100 million. It accounts for the $10 million milestone payment in accordance with the royalty recognition constraint and only recognizes revenue for the milestone payment once the customer's sales reach $100 million.

[233] Paragraph BC78(b) of ASU 2016-10.

Question 8-5 **Can an entity recognize revenue for sales- or usage-based royalties for licenses of intellectual property on a lag if actual sales or usage data is not available at the end of a reporting period?**

The standard states that sales-or usage-based royalties promised in exchange for licenses of intellectual property should be recognized as revenue at the later of when the (1) subsequent sales or usage occurs or (2) the performance obligation to which the sales- or usage-based royalties relates has been satisfied (or partially satisfied). Therefore, after the conditions in the royalty constraint guidance have been met (i.e., the underlying sales or usage has occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied)), we believe that licensors without actual sales or usage data from the licensee will need to make an estimate of royalties earned in the current reporting period in accordance with the general model in Step 3, which would include consideration of the general constraint on variable consideration.

The Deputy Chief Accountant of the SEC's Office of the Chief Accountant noted in a speech[234] that because the FASB did not provide "a lagged reporting exception" in the new standard, the reporting of sales- and usage-based royalties may require estimation in some circumstances. This may result in a change in practice for entities that have previously recorded revenue from royalties on a lag (i.e., in a reporting period subsequent to when the underlying sales or usage occurs).

[234] Speech by Wesley R. Bricker, 9 June 2016. Refer to SEC website at https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html.

9 Other measurement and recognition topics

9.1 Warranties

Warranties are commonly included in arrangements to sell goods or services. They can be explicitly stated or implied based on an entity's customary business practices. The standard includes the follow guidance on warranties:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Warranties

606-10-55-30

It is common for an entity to provide (in accordance with the contract, the law, or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

The price of a warranty may be included in the overall purchase price or listed separately as an optional product. The standard identifies two types of warranties:

- Warranties that promise the customer that the delivered product is as specified in the contract (called "assurance-type warranties")
- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (called "service-type warranties")

9.1.1 Determining whether a warranty is a service- or assurance-type warranty

The standard provides the following guidance on determining whether a warranty is a service- or assurance-type warranty:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Warranties

606-10-55-31

If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

606-10-55-32

If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. Otherwise, it is an assurance-type warranty, which provides the customer with assurance that the product complies with agreed-upon specifications. In some cases, it may be difficult to determine whether a warranty provides a customer with a service in addition to the assurance that the delivered product is as specified in the contract. To help entities make that assessment, the standard provides the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Warranties

606-10-55-33

In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

a. Whether the warranty is required by law — If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

b. The length of the warranty coverage period — The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

c. The nature of the tasks that the entity promises to perform — If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

606-10-55-35

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products does not give rise to a performance obligation. The entity should account for such obligations in accordance with the guidance on loss contingencies in Subtopic 450-20 on contingencies.

How we see it

Entities may need to exercise significant judgment when determining whether a warranty is an assurance-type or service-type warranty. An entity's evaluation may be affected by several factors, including common warranty practices within its industry and the entity's business practices related to warranties. For example, consider an automotive manufacturer that provides a five-year warranty on a luxury vehicle and a three-year warranty on a standard vehicle. The manufacturer may conclude that the longer warranty period is not an additional service because it believes the materials used to construct the luxury vehicle are of a higher quality, and latent defects would take longer to appear. In contrast, the manufacturer might consider the length of the warranty period and the nature of the services provided under the warranty and conclude that the five-year warranty period, or some portion of it, is an additional service that should be accounted for as a service-type warranty.

Question 9-1 **How should an entity evaluate whether a product warranty is a service-type warranty (i.e., a performance obligation) when it is not separately priced?** [30 March 2015 TRG meeting; agenda paper no. 29]

TRG members generally agreed that the evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications will require judgment and depend on the facts and circumstances. There is no bright line in the standard on what constitutes a service-type warranty beyond it being separately priced.

However, the standard includes three factors that should be considered in each evaluation (i.e., whether the warranty is required by law, the length of the warranty coverage and the nature of the tasks that the entity promises to perform, as stated in ASC 606-10-55-33).

Consider the following example from the TRG agenda paper: A luggage company provides a lifetime warranty to repair broken or damaged baggage free of charge. The luggage company evaluates the three factors and determines that they indicate the warranty is a performance obligation in addition to the assurance that the product complies with agreed-upon specifications because (1) there is no law that requires the luggage company to make a promise for the lifetime of the product, (2) the length of the warranty is for the life of the baggage and (3) the tasks include both repairs to baggage that does not meet the promised specifications and repairs for broken or damaged baggage.

Further, the TRG agenda paper emphasized that entities should not assume that legacy accounting will remain unchanged under the new standard. Entities will need to evaluate each type of warranty offered to determine the appropriate accounting.

Question 9-2 **Should repairs provided outside the warranty period be accounted for as a service-type warranty?**

We believe entities will need to carefully consider the factors in ASC 606-10-55-33 (e.g., the nature of the services provided, the length of the implied warranty period) to determine whether services provided outside the warranty period represent a service-type warranty. Sometimes, entities provide these services as part of their customary business practices, in addition to providing assurance-type warranties for specified periods of time. For example, an equipment manufacturer gives its customers a standard product warranty that provides assurance that the product complies with agreed-upon specifications for one year from the date of purchase. However, the entity provides an implied warranty by frequently repairing products for free after the one-year standard warranty period has ended. See Section 4.1 for a discussion of implied performance obligations.

If the entity determines that the repairs made during the implied warranty period generally involve defects that existed when the product was sold and the repairs occur shortly after the assurance warranty period, the entity may conclude that the repairs are covered by an assurance-type warranty. That is, the term of the assurance-type warranty may be longer than that stated in the contract. However, all facts need to be considered to reach a conclusion.

Question 9-3 **Should an entity account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item) as a right of return or an assurance-type warranty?**

We believe that an entity should account for the right to return a defective item for cash (instead of a replacement item) under the right of return guidance in ASC 606-10-55-22 through 55-29 rather than as an assurance-type warranty. The Basis for Conclusions of ASU 2014-19[235] states that "… the Boards decided that an entity should recognize an assurance-type warranty as a separate liability to replace or repair a defective product." This description of an assurance-type warranty does not include defective products that are returned for a refund; it only contemplates defective products that are replaced or repaired. See Section 5.4.1 for a discussion of rights of return.

However, there may be limited circumstances in which cash paid to a customer for a defective item should be accounted for in accordance with the warranty guidance instead of the variable consideration guidance. For example, an entity may pay cash to a customer as reimbursement for third-party costs incurred to repair a defective item. In this case, the cash payment to the customer was incurred to fulfill the entity's warranty obligation. This assessment will require judgment and depend on the facts and circumstances.

Question 9-4 **Should liquidated damages, penalties or compensation from other similar clauses be accounted for as variable consideration or warranty provisions under the standard?**

See response to Question 5-3 in Section 5.2.1.

9.1.2 Service-type warranties

The Board determined[236] that a service-type warranty represents a distinct service and is a separate performance obligation. Therefore, an entity allocates a portion of the transaction price to the service-type warranty based on the estimated standalone selling price of the service-type warranty. The entity then recognizes revenue allocated to the service-type warranty over the period the warranty service is provided because the customer will likely receive and consume the benefits of the warranty as the entity performs (i.e., the warranty performance obligation is likely satisfied over time in accordance with ASC 606-10-25-27(a), see Section 7.1.1).

Judgment may be required to determine the appropriate pattern of revenue recognition associated with service-type warranties. For example, an entity may determine that it provides the warranty service continuously over the warranty period (i.e., the performance obligation is an obligation to "stand ready to perform" during the stated warranty period). An entity that makes this determination will likely recognize revenue ratably over the warranty period. An entity also may conclude that a different pattern of recognition is appropriate based on data it has collected about when it provides services. For example, an entity might recognize little or no revenue in the first year of a three-year service-type warranty if its historical data indicates that it provides warranty services only in the second and third years of the warranty period. Section 7.1.4 describes considerations for determining the appropriate pattern of revenue recognition, including for stand-ready obligations. If payment for the service-type warranty is received upfront, an entity should also evaluate whether a significant financing component exists (see Section 5.5).

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[235] Paragraph BC376 of ASU 2014-09.

[236] Paragraph BC371 of ASU 2014-09.

Changes in the estimate of the costs to satisfy service-type warranty performance obligations do not result in a revision to the original relative standalone selling price allocation (or the resulting allocated amount of the transaction price that will be recognized as revenue for the service-type warranty performance obligation). For example, an entity may discover two months after a product is shipped that the cost of a part acquired from a third-party manufacturer has tripled and that it will cost the entity significantly more to replace that part if a warranty claim is made. This change will not affect the amount of transaction price that the entity allocated to the service-type warranty because the estimate of standalone selling prices is performed at contract inception and is not updated to reflect changes between contract inception and when performance is complete. Therefore, the service-type warranty cost recognition does not affect the revenue recognition. However, for future contracts involving the same warranty, the entity would need to determine whether to revise the standalone selling price because of the significant increase in the costs to satisfy the warranty and, if so, use that revised price for future allocations (see Section 6.1.3).

9.1.3 Assurance-type warranties

The Board concluded[237] that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a guarantee of quality. Under the standard, these types of warranties are accounted for as warranty obligations, and the estimated cost of satisfying them is accrued in accordance with the guidance in ASC 460-10 on guarantees. Once recorded, the warranty liability should be assessed on an ongoing basis also in accordance with ASC 460-10.

ASC 460-10-25-6 indicates that if the costs of satisfying future warranty obligations cannot be reasonably estimated at the transaction date, a reserve for warranty obligations cannot be accrued, and if the range of possible loss is wide, may raise a question about whether revenue should be recorded until a reasonable estimate can be made or the warranty period expires.

9.1.4 Contracts that contain both assurance- and service-type warranties

Some contracts may include both an assurance-type warranty and a service-type warranty. The standard provides the following guidance for these situations:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Warranties

606-10-55-34

If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

[237] Paragraph BC376 of ASU 2014-09.

When an assurance-type warranty and a service-type warranty can be accounted for separately, an entity is required to accrue for the expected costs associated with the assurance-type warranty and defer the revenue for the service-type warranty as illustrated below:

Illustration 9-1: Service-type and assurance-type warranties

An entity manufactures and sells computers that include an assurance-type warranty for the first 90 days. The entity offers an optional "extended coverage" plan under which it will repair or replace any defective part for three years from the expiration of the assurance-type warranty. Because the optional "extended coverage" plan is sold separately, the entity determines that the three years of extended coverage represent a separate performance obligation (i.e., a service-type warranty).

The total transaction price for the sale of a computer and the extended warranty is $3,600. The entity determines that the standalone selling prices of the computer and the extended warranty are $3,200 and $400, respectively. The inventory value of the computer is $1,440. Further, the entity estimates that, based on its experience, it will incur $200 in costs to repair defects that arise within the 90-day coverage period for the assurance-type warranty. As a result, the entity will record the following entries:

Dr. Cash/receivables	3,600	
Dr. Warranty expense	200	
Cr. Accrued warranty costs (assurance-type warranty)		200
Cr. Contract liability (service-type warranty)		400
Cr. Revenue		3,200
To record revenue and contract liabilities related to warranties.		

Dr. Cost of sales	1,440	
Cr. Inventory		1,440
To relieve inventory and recognize cost of sales.		

The entity derecognizes the accrued warranty liability associated with the assurance-type warranty as actual warranty costs are incurred during the first 90 days after the customer receives the computer. The entity recognizes the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognizes the costs associated with providing the service-type warranty as they are incurred. The entity would need to be able to determine whether repair costs incurred should be applied against the warranty reserve it already established for claims that occur during the first 90 days or recognized as an expense in the period incurred.

Accounting for both assurance-type warranties and service-type warranties in the same transaction may be complex. Entities may need to develop processes to match individual warranty claims with the specific warranty plans so claims can be analyzed for appropriate accounting treatment. This individual assessment of warranty claims is necessary because the assurance-type warranty costs will have been accrued previously, while the service-type warranty costs are expenses that need to be recognized in the period in which they are incurred as illustrated below:

Illustration 9-2: Service-type and assurance-type warranty costs

Assume the same facts as in Illustration 9-1, but assume the entity sold 500 computers during the year. In January of the following year, $10,000 of warranty claims are submitted by customers. The entity analyzes each claim and identifies the specific computer sale to which the claim is related. The entity needs to do this in order to determine eligibility and the appropriate accounting treatment under the warranty plans.

The entity determines that a portion of the claims, totaling $2,500 for repair and replacement parts, are covered by the assurance-type warranty plan. As shown above in Illustration 9-1, the expected cost of each assurance-type warranty was accrued at the time of the sale. The entity records the following entry to derecognize a portion of the warranty liability:

Dr. Accrued warranty costs (assurance-type warranty)	2,500	
Cr. Cash		2,500

To derecognize the assurance-type warranty liability as the costs are incurred.

The entity also determines that a portion of the claims, totaling $7,000 for repair and replacement parts, are eligible under the "extended coverage" plan (i.e., the service-type warranty). The entity records the following entry to recognize the costs associated with the service-type warranty:

Dr. Warranty expense	7,000	
Cr. Cash		7,000

To record the costs of the service-type warranty as the costs are incurred.

The entity also determines that $500 of the claims are not eligible under either warranty plan because the claims relate to incidents that occurred after the 90-day coverage period for the assurance-type warranty, and the customers in those transactions did not purchase the extended warranty coverage (i.e., the service-type warranty). The entity rejects these customer claims.

How we see it

The guidance for assurance-type warranties is essentially the same as legacy practice. The guidance for service-type warranties is similar to legacy GAAP, except for the amount of transaction consideration that is allocated to the warranty performance obligation. Under legacy GAAP, entities that provide separately priced extended warranties defer an amount equal to the stated price of the warranty and record that amount as revenue over the warranty period. The new standard requires an entity to defer an allocated amount based on a relative standalone selling price allocation, so an entity may need to enhance its processes and controls to allocate the transaction price between performance obligations in the contract.

9.2 Loss contracts

The Board decided[238] to retain existing guidance for situations in which an entity is expected to incur a loss on a contract (with certain consequential amendments to reflect the terminology of, and cross-references to, the new revenue guidance, where appropriate). While guidance exists for some industries or for certain types of transactions, there is no general authoritative guidance on when to recognize losses on onerous contracts and, if a loss is to be recognized, how to measure the loss. Accordingly, diversity in practice exists when such contracts are not within the scope of specific authoritative literature.

Legacy GAAP that requires accrual of expected losses on contracts includes the following:

- A firm purchase commitment for goods or inventory subject to ASC 440-10-25-4
- Contracts within the scope of ASC 605-35
- An operating lease that is subleased subject to ASC 840 or ASC 420
- Certain other executory contracts subject to ASC 420

[238] Paragraph BC296 of ASU 2014-09.

- An insurance contract with a premium deficiency subject to ASC 944
- Losses on prepaid health care services subject to ASC 954-450
- Certain derivative contracts within the scope of ASC 815
- Losses on arrangements accounted for pursuant to ASC 985-605

Entities will continue to be required to follow legacy guidance for onerous contracts.[239] For example, entities that fall within the scope of the legacy accounting guidance in ASC 605-35 and are required to account for expected losses on contracts would continue to follow that guidance after adoption of ASU 2014-09 (assuming they continue to meet the scope criteria in ASC 605-35, as amended by ASU 2014-09). However, as noted above, there were consequential amendments to some of the legacy cost guidance. For example, the guidance in ASC 605-35 has been updated to require entities to use the principles in ASC 606 when determining the transaction price (except for the guidance on constraining estimates of variable consideration) for purposes of estimating the expected loss on the contract. Entities should consider the updated guidance and terminology when applying the retained legacy cost guidance.

UPDATE: In May 2016, the FASB proposed clarifying that the provision for losses under ASC 605-35 be determined at least at the contract level. However, the proposed amendments would allow an entity to determine the provision for losses at the performance obligation level as an accounting policy election. Comments were due 2 July 2016. To finalize this change, the FASB will need to issue a final ASU.

IASB differences

Under IFRS, the accounting for onerous contracts under IAS 37 applies to all contracts in the scope of the revenue standard and requires entities to recognize and measure liabilities for onerous contracts. The liability amount is the lower of the cost to exit (i.e., any compensation or penalties arising from failure to fulfill the contract) or to fulfill the remaining obligations under a contract.

9.3 Contract costs

ASU 2014-09 also added ASC 340-40 to codify the guidance on other assets and deferred costs relating to contracts with customers. This guidance specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers as described below:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Scope

Transactions

606-10-15-5

Subtopic 340-40 on other assets and deferred costs from contracts with customers includes guidance on accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfill a contract with a customer if those costs are not within the scope of another Topic (see Subtopic 340-40). An entity shall apply that guidance only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of the guidance in this Topic.

[239] Paragraph BC296 of ASU 2014-09.

Question 9-5 **Can entities apply the portfolio approach practical expedient for the evaluation of and/or accounting for contracts costs under ASC 340-40?**

ASC 606 includes a practical expedient, as described in ASC 606-10-10-4, that allows for the use of a portfolio approach if the entity reasonably expects that the effects on the financial statements would not materially differ from applying the revenue guidance to individual contracts (see Section 3.3.1). While a similar practical expedient was not codified in ASC 340-40, we believe the portfolio approach can be applied to the evaluation of contract costs accounted for in accordance with the guidance in ASC 340-40 (e.g., for amortizing costs to obtain or fulfill a contract with a customer).

The FASB and the IASB developed the guidance on accounting for contracts with customers (including both revenues and costs) as part of one joint project. When the new guidance was finalized for US GAAP, the FASB split the revenue and costs guidance into ASC 606 and ASC 340-40, due to the structure and format of accounting topics within the Codification. Under IFRS, the converged guidance on revenue and costs are both in IFRS 15. Therefore, under IFRS 15, the guidance developed by the IASB on the use of the portfolio approach can be applied to both contract revenues and costs. We believe that the Boards did not intend for there to be a difference in how the portfolio approach could be applied under US GAAP and IFRS.

This view was also expressed in TRG agenda paper no. 23, which stated, "[p]er paragraph 606-10-10-4 …, an entity might take advantage of the practical expedient to account for the incremental costs of obtaining a contract at a portfolio level (for example, in determining an amortization period). An entity's specific facts and circumstances will dictate whether it can apply the guidance at a portfolio level."

9.3.1 Costs to obtain a contract

Under ASC 340-40, the incremental costs of obtaining a contract with a customer are recognized as an asset if the entity expects to recover them as follows:

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Scope and Scope Exceptions

Incremental Costs of Obtaining a Contract with a Customer

340-40-15-2

The guidance in this Subtopic applies to the incremental costs of obtaining a contract with a customer within the scope of Topic 606 on revenue from contracts with customers (excluding any consideration payable to a customer, see paragraphs 606-10-32-25 through 32-27).

Recognition

Incremental Costs of Obtaining a Contract

340-40-25-1

An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

340-40-25-2

The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

> *340-40-25-3*
>
> Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.
>
> *340-40-25-4*
>
> As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Before applying the cost guidance, entities will need to consider the scoping provisions of the guidance. Specifically, an entity will need to first consider whether the guidance on consideration payable to a customer under ASC 606 (see Section 5.7 for a discussion on accounting for consideration paid or payable to a customer) applies to the costs.

To qualify for capitalization, contract acquisition costs must be incremental, and the entity must expect to recover them. Incremental costs are those that an entity would not have incurred if the contract had not been obtained. For example, salaries and benefits of sales employees that are incurred (i.e., paid to the employee) regardless of whether a contract was obtained are not incremental costs. An entity can expect to recover contract acquisition costs through direct recovery (i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract).

The standard cites sales commissions as a type of an incremental cost that may require capitalization under the standard. For example, commissions that are related to sales from contracts signed during the period may represent incremental costs that would require capitalization. The standard does not explicitly address considerations for different types of commission programs, so entities will have to exercise judgment to determine whether sales commissions are incremental costs and if so, the point in time when the costs should be capitalized. For example, variable commissions, commissions paid for contract renewals or modifications, commissions paid to supervisors and commissions not directly linked to any single contract (e.g., commissions based on reaching a specified level of sales overall) may require additional analysis.

TRG members[240] discussed the underlying principle for capitalizing costs under the standard and generally agreed that neither ASC 340-40 nor ASC 606 amended US GAAP liability guidance. Therefore, entities should first refer to the applicable liability standard to determine when they are required to accrue for certain costs. Entities would then use the guidance in ASC 340-40 to determine whether the related costs need to be capitalized. TRG members acknowledged that certain aspects of the cost guidance will require entities to apply significant judgment to analyze the facts and circumstances and to determine the appropriate accounting.

In addition, the TRG agenda paper[241] observed that incremental costs of obtaining a contract are not limited to initial incremental costs. Commissions recognized subsequent to contract inception (e.g., commissions paid on modifications, commissions subject to contingent events or clawback) because they did not meet the liability recognition criteria at contract inception should still be considered for capitalization as costs to obtain the contract when the liability is recognized. This would include contract renewals because, as the TRG agenda paper said, a renewal contract *is* a contract and there isn't anything in the guidance on costs to obtain a contract to suggest a different treatment for contracts that are renewals of existing contracts. That is, the only difference between the two costs would be the timing of recognition based on when a liability has been incurred.

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[240] 26 January 2015 TRG meeting; agenda paper no. 23.

[241] 26 January 2015 TRG meeting; agenda paper no. 23.

The following example illustrates how these principles may be applied to a fact pattern with sales commissions paid to a supervisor and sales commissions paid for renewals:

Illustration 9-3: Sales commissions

Entity X has a commission plan whereby each salesperson is paid $1,000 for each new contract entered into with a customer as a result of the salesperson's efforts. The salesperson is also paid $200 every time that customer renews its contract with the company. The Vice President (VP) of sales also receives a $50 commission every time an initial contract or renewal is signed, which is not contingent on other performance metrics. The margin inherent in each new contract is sufficient to recover the commissions for each new contract and renewal.

Entity X would record a liability of $1,050 (the commission for the salesperson and the VP of sales) at contract inception, as that is the point in time when the commissions are probable and estimable under ASC 710. The entity would separately evaluate the commissions paid to the salesperson and to the VP of sales to determine whether it would have incurred those commissions if it had not obtained the contract and whether it will recover them. If Entity X determines these criteria are met for both commissions, it would capitalize $1,050 when the liability is recognized.

Entity X would likewise record a liability of $250 when each renewal is signed because that is the point in time when the renewal commissions are probable and estimable and would evaluate whether the commissions would not have been incurred if the renewal contract had not been obtained and are recoverable. Even if the renewal was anticipated at contract inception, the estimated commission would not be accrued or capitalized at that time because a liability has not been incurred for the renewal at contract inception.

Unlike many commissions, some incentive payments such as bonuses and other compensation that are based on quantitative or qualitative metrics not related to contracts obtained (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not incremental costs of obtaining a contract. However, a legal contingency cost may be an incremental cost of obtaining a contract if a lawyer agrees to receive payment only upon the successful completion of a negotiation. Determining which costs must be capitalized under the standard may require judgment.

ASC 340-40 provides the following example regarding incremental costs of obtaining a contract:

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Implementation and Guidance Illustrations

Example 1 — Incremental Costs of Obtaining a Contract

340-40-55-2

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new **customer**. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$ 15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$ 50,000

340-40-55-3

In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

340-40-55-4

The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

How we see it

The new guidance will require a significant change in practice for entities that historically have expensed the costs of obtaining a contract and now will be required to capitalize them. In addition, this may be a significant change for entities that have previously capitalized costs to obtain a contract, such as salaries and benefits for salespeople, by analogizing to the guidance in ASC 310-20. Because such amounts are not incremental, they would not be eligible for capitalization under the new standard unless they are explicitly chargeable to the customer regardless of whether the contract is obtained.

As a practical expedient, the standard permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. While this is not explicitly stated in the standard, we believe entities should apply this approach consistently to all short-term acquisition costs.

Question 9-6

Should an entity capitalize commissions paid on contract modifications? [26 January 2015 TRG meeting; agenda paper no. 23]

Yes, if they are incremental (i.e., they would not have been incurred if there hadn't been a modification) and recoverable. Contract modifications are accounted for in one of three ways: (1) as a separate contract, (2) as a termination of the existing contract and the creation of a new contract or (3) as part of the existing contract (see Section 3.4 for further guidance on contract modifications). In all three cases, commissions paid on contract modifications are incremental costs of obtaining a contract and should be capitalized if they are recoverable. In the first two cases, a new contract is created so the costs of obtaining that contract would be incremental. The TRG agenda paper said that commissions paid on the modification of a contract that is accounted for as part of the existing contract are incremental costs even though they are not *initial* incremental costs.

Question 9-7 **Should fringe benefits (e.g., employer portion of payroll taxes, pension/401-K matches) on commission payments be included in the capitalized amounts?** [26 January 2015 TRG meeting; agenda paper no. 23]

Fringe benefits should be capitalized as part of the incremental cost of obtaining a contract if the additional costs are based on the amount of commissions paid and the commissions qualify as costs to obtain a contract. However, if the costs of fringe benefits would have been incurred regardless of whether the contract had been obtained (e.g., health insurance premiums), the fringe benefits should not be capitalized. That is, an entity cannot allocate to the commission and therefore capitalize a portion of the costs of benefits it would provide regardless of whether the commission was paid.

Question 9-8 **Must an entity apply the practical expedient to expense contract acquisition costs to all of its qualifying contracts across the entity or can it apply the practical expedient to individual contracts?**

We believe the practical expedient to expense contract acquisition costs that would be amortized over a period of one year or less should be applied consistently to contracts with similar characteristics and in similar circumstances. Therefore, we believe an entity generally should apply the practical expedient to expense contract acquisition costs to all of its qualifying contracts at the entity-wide level.

Question 9-9 **How should an entity account for capitalized commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract?**

We believe an asset recognized for incremental costs to obtain a contract that exists when the related contract is modified should be carried forward into the new contract if the modification is treated as the termination of an existing contract and the creation of a new contract and the goods and services to which the original contract cost asset relates are part of the new contract. That is because the contract cost asset relates to goods and services that have not been transferred and the accounting for the modification is prospective. This conclusion is similar to the one reached by FASB TRG members in relation to the accounting for contract assets upon a contract modification, as discussed in Question 10-5 in Section 10.1.The contract cost asset that remains on the entity's balance sheet at the date of modification would continue to be evaluated for impairment in accordance with ASC 340-40 (see Section 9.3.4). In addition, an entity should determine an appropriate amortization period for the contract cost asset (see Section 9.3.3).

9.3.2 Costs to fulfill a contract

ASC 340-40 divides contract fulfillment costs into two categories: (1) those that give rise to an asset and (2) those that are expensed as incurred. When determining the appropriate accounting treatment for these costs, the guidance states that any other applicable literature should be considered first as follows:

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Scope and Scope Exceptions

Costs Incurred in Fulfilling a Contract with a Customer

340-40-15-3

The guidance in this Subtopic applies to the costs incurred in fulfilling a contract with a customer within the scope of Topic 606 on revenue from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory

b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements

c. Subtopic 350-40 on internal-use software

d. Topic 360 on property, plant, and equipment

e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

Recognition

Costs to Fulfill a Contract

340-40-25-5

An entity shall recognize an asset from the costs incurred to fulfill a contract **only if those costs meet all of the following criteria:**

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations **in the future.**

c. The costs are expected to be recovered.

340-40-25-6

For costs incurred in fulfilling a contract with a **customer** that are within the scope of another Topic (for example, Topic 330 on inventory; paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements; Subtopic 350-40 on internal-use software; Topic 360 on property, plant, and equipment; or Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed), an entity shall account for those costs in accordance with those other Topics or Subtopics.

If other accounting guidance precludes the recognition of an asset for a particular cost, an asset cannot be recognized under ASC 340-40.

When determining whether costs meet the criteria for capitalization, an entity must consider its specific facts and circumstances. The standard says that costs can be capitalized even if the revenue contract with the customer is not finalized. However, rather than allowing costs to be related to any potential future contract, the standard requires that the costs be associated with a specific anticipated contract.

The standard discusses and provides examples of costs that may meet the first criterion for capitalization listed above (i.e., costs that relate directly to the contract) as follows:

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Recognition

Costs to Fulfill a Contract

340-40-25-7

Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)

b. Direct materials (for example, supplies used in providing the promised services to a customer)

c. Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)

d. Costs that are explicitly chargeable to the customer under the contract

e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

Significant judgment may be required to determine whether costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. In the Basis for Conclusions of ASU 2014-09,[242] the FASB explained that the standard results in the capitalization of only costs that meet the definition of an asset and precludes an entity from deferring costs merely to normalize profit margins throughout a contract by allocating revenue and costs evenly over the contract term.

For costs to meet the "expected to be recovered" criterion, the costs need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin.

If the costs incurred in fulfilling a contract do not give rise to an asset based on the criteria above, the guidance requires them to be expensed as incurred. The standard provides some common examples of costs that should be expensed as incurred as follows:

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Recognition

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).

If a performance obligation (or a portion of a performance obligation that is satisfied over time) has been satisfied, fulfillment costs related to that performance obligation (or portion thereof) can no longer be capitalized. Once an entity has begun satisfying a performance obligation that is satisfied over time, it should only capitalize costs that relate to future performance. If an entity is unable to determine whether certain costs relate to past or future performance, and the costs are not eligible for capitalization under other US GAAP guidance, the costs are expensed as incurred.

[242] Paragraph BC308 of ASU 2014-09.

The standard provides the following example that illustrates costs that are capitalized under other US GAAP, costs that meet the capitalization criteria and costs that don't:

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Implementation Guidance and Illustrations

Example 2 — Costs that Give Rise to an Asset

340-40-55-5

An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a $10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

Incremental Costs of Obtaining a Contract

340-40-55-6

In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided. The entity amortizes the asset over seven years in accordance with paragraph 340-40-35-1 because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

Costs to Fulfill a Contract

340-40-55-7

The initial costs incurred to set up the technology platform are as follows:

Design services	$ 40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	100,000
Total costs	$ 350,000

340-40-55-8

The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

a. Hardware costs — accounted for in accordance with Topic 360 on property, plant, and equipment

b. Software costs — accounted for in accordance with Subtopic 350-40 on internal-use software

c. Costs of the design, migration, and testing of the data center — assessed in accordance with paragraph 340-40-25-5 to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.

340-40-55-9

In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 340-40-25-5(b)). Therefore, the costs do not meet the criteria in paragraph 340-40-25-5 and cannot be recognized as an asset using this Topic. In accordance with paragraph 340-40-25-8, the entity recognizes the payroll expense for these two employees when incurred.

Question 9-10

How should an entity account for pre-production costs related to long-term supply arrangements that are accounted for under ASC 340-10 prior to the adoption of ASU 2014-09? [9 November 2015 TRG meeting; agenda paper no. 46]

ASU 2014-09 did not amend the guidance in ASC 340-10 on pre-production costs related to long-term supply arrangements. FASB TRG members generally agreed that an entity that was appropriately following the guidance in ASC 340-10 before the adoption of ASU 2014-09 would continue to do so after implementation of ASU 2014-09. However, several FASB TRG members questioned whether the guidance in ASC 340-10 should be rescinded because it appears to be unnecessary and is potentially inconsistent with the revenue and cost guidance in ASU 2014-09.

UPDATE: In May 2016, the FASB proposed superseding the guidance in ASC 340-10. Under this proposal, an entity would apply ASC 340-40 to determine whether pre-production costs should be capitalized as long as those costs are not in the scope of other authoritative accounting literature (e.g., ASC 720-15, ASC 730). Comments were due 2 July 2016. To finalize this change, the FASB will need to issue a final ASU.

Question 9-11

Will pre-production costs for construction-type and production-type contracts that were previously in the scope of ASC 605-35 be in the scope of the cost guidance in ASC 340-10 or ASC 340-40? [9 November 2015 TRG meeting; agenda paper no. 46]

The contract cost guidance in ASC 605-35 will be superseded by ASU 2014-09. FASB TRG members generally agreed that an entity that is appropriately accounting for contract costs under ASC 605-35 prior to the adoption of ASU 2014-09 would account for those contract costs under ASC 340-40 after adopting ASU 2014-09.

Question 9-12

Can an entity defer costs of a transferred good or service that would otherwise generate an up-front loss because variable consideration is fully or partially constrained?

An entity should not defer the costs of a transferred good or service when the application of the constraint on variable consideration results in an up-front loss even if the entity ultimately expects to recognize a profit on that good or service, unless other specific guidance requires a deferral of those costs. The criteria in ASC 340-40 must be met to capitalize costs to fulfill a contract, including the criterion that the costs must generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. An entity recognizes costs of sales when control of a good or service transfers to the customer, so the cost of those sales would not generate or enhance resources used to satisfy future performance obligations. Consider the following example:

An entity sells goods with a cost of $500,000 for consideration of $600,000. The goods have a high risk of obsolescence, which may require the entity to provide price concessions in the future, resulting in variable consideration (see Section 5.2.1.1). The entity constrains the transaction price and concludes that it is probable that $470,000 will not result in a significant revenue reversal even though the vendor reasonably expects the contract to be ultimately profitable. When control transfers, the entity recognizes revenue of $470,000 and costs of $500,000 and would not capitalize the loss of $30,000 because the loss does not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

Question 9-13 **How should an entity account for fulfillment costs incurred prior to the contract establishment date that are outside the scope of another standard (e.g., outside of the scope of the inventory guidance in ASC 330)?** [30 March 2015 TRG meeting; agenda paper no. 33]

Entities may begin activities on a specific anticipated contract before the contract establishment date (e.g., before agreeing to the contract with the customer, before the contract satisfies the criteria to be accounted for under the standard). TRG members generally agreed that costs relating to pre-contract establishment date activities that relate to a good or service that will transfer to the customer at or after the contract establishment date may be capitalized as costs to fulfill a specific anticipated contract. However, TRG members noted such costs would still need to meet the other criteria in the standard to be capitalized (e.g., they are expected to be recovered under the anticipated contract).

Capitalized costs that relate to goods or services that are transferred to the customer at the contract establishment date should be expensed immediately. Any remaining capitalized costs would be amortized over the period that the related goods or services are transferred to the customer.

For guidance on recognizing revenue for a performance obligation satisfied over time when activities are completed before the contract establishment date, see Question 7-8 in Section 7.1.4.3.

9.3.3 Amortization of capitalized costs

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer as follows:

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Subsequent Measurement

Amortization and Impairment

340-40-35-1

An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 340-40-25-5(a)).

340-40-35-2

An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

It is important to note that certain capitalized costs will relate to multiple goods and services (e.g., design costs to manufacture multiple distinct goods when design services are not a separate performance obligation) in a single contract, so the amortization period could be the entire contract term. The amortization period could also extend beyond a single contract if the capitalized costs relate to goods or services being transferred under multiple contracts, or to a specific anticipated contract, such as when the customer is expected to renew its current services contract for another term. In these situations, the capitalized costs should be amortized over the expected period of benefit. The expected period of benefit may be the expected customer relationship period. To determine the appropriate amortization period, an entity will need to evaluate the type of capitalized costs, what the costs relate to and the specific facts and circumstances of the arrangement.

When evaluating whether the amortization period for a sales commission extends beyond the contract period, an entity should also evaluate whether an additional commission is paid for subsequent renewals. In the Basis for Conclusions of ASU 2014-09,[243] the FASB explained that amortizing the asset over a longer period than the initial contract would not be appropriate if an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the costs of obtaining the initial contract do not relate to the subsequent contract. Judgment will be required to determine whether a renewal commission is commensurate with the commission paid on the initial contract.

An entity should update the amortization period when there is a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates, as illustrated in the following example:

Illustration 9-4: Amortization period

Entity A enters into a three-year contract with a new customer for transaction processing services. To fulfill the contract, Entity A incurred setup costs of $60,000, which it capitalized in accordance with ASC 340-40-25-5 through 25-8 and will amortize over the term of the contract.

At the beginning of the third year, the customer renews the contract for an additional two years. Because Entity A will benefit from the setup costs during the additional two-year period, it would change the remaining amortization period from one to three years and adjust the amortization expense in the period of the change and future periods in accordance with the guidance in ASC 250 on changes in estimates. The disclosure requirements of ASC 250 related to changes in estimates also are applicable.

However, under the standard, if Entity A had been in the position to anticipate the contract renewal at contract inception, Entity A would have amortized the setup costs over the anticipated term of the contract, including the expected renewal (i.e., five years).

[243] Paragraph BC309 of ASU 2014-09.

Question 9-14 **Can an entity attribute the capitalized contract costs to the individual performance obligations in the contract to determine the appropriate amortization period?**

Yes, we believe an entity can attribute the capitalized contract costs to the individual performance obligations in the contract to determine the appropriate amortization period, but it is not required to do so. ASC 340-40-35-1 states that the asset recognized should be amortized on a systematic basis "that is consistent with the transfer to the customer of the goods or services to which the asset relates." An entity may meet this objective by allocating the capitalized costs to performance obligations on a relative basis (i.e., in proportion to the transaction price allocated to each performance obligation) to determine the period of amortization.[244] An entity may also meet the objective by allocating specific capitalized costs to individual performance obligations when the costs relate specifically to certain goods or services. An entity should have objective evidence to support a conclusion that a specified amount of the costs relates to a specific performance obligation.

In addition, as discussed above, an entity that attributes capitalized contract costs to individual performance obligations will need to consider whether the amortization period for some or all of the performance obligations should extend beyond the original contract.

Question 9-15 **Over what period should an entity amortize a sales commission that is paid only once a threshold is met that is determined to be an incremental cost to obtain a contract?** [26 January 2015 TRG meeting; agenda paper no. 23]

The TRG agenda paper said two of the alternatives discussed would meet the objective of amortizing the costs on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates, but either alternative should be applied consistently to similar circumstances. In one alternative, an entity allocated the capitalized costs to all of the contracts that cumulatively resulted in the threshold being met and amortized the costs over the expected customer relationship period of each of those contracts. In the other alternative, an entity allocated the capitalized costs to the contract that resulted in the threshold being met and amortized the costs over the expected customer relationship period of that contract. The TRG agenda paper noted that the second alternative may result in a counterintuitive answer if the commission paid upon obtaining the contract that resulted in the threshold being met was large in relation to the transaction price for only that contract. The TRG agenda paper did not contemplate all possible alternatives.

9.3.4 Impairment of capitalized costs

Because costs that give rise to an asset must continue to be recoverable throughout the contract period (or period of benefit, if longer) to meet the criteria for capitalization, any asset recorded by the entity is subject to an impairment assessment at the end of each reporting period as follows:

[244] 26 January 2015 TRG meeting; agenda paper no. 23.

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Subsequent Measurement

Amortization and Impairment

340-40-35-3

An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 exceeds:

a. The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates, less

b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraph 340-40-25-7).

340-40-35-4

For the purposes of applying paragraph 340-40-35-3 to determine the amount of consideration that an entity expects to receive, an entity shall use the principles for determining the transaction price (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk.

340-40-35-5

Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic (for example, Topic 330 on inventory; Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed; Topic 360 on property, plant, and equipment; and Topic 350 on goodwill and other intangibles). After applying the impairment test in paragraph 340-40-35-3, an entity shall include the resulting carrying amount of the asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in Topics 360 and 350 to that asset group or reporting unit.

340-40-35-6

An entity shall not recognize a reversal of an impairment loss previously recognized.

An impairment exists if the carrying amount of any asset(s) exceeds the amount of consideration the entity has received that has not been recognized as revenue and consideration it expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those goods and services.

TRG members[245] generally agreed that an entity should include future cash flows associated with contract renewal or extension periods when it determines the amount it expects to receive for purposes of the impairment test if the period of benefit of the costs under assessment is expected to extend beyond the present contract. In other words, an entity should consider the total period over which it expects to receive economic benefits relating to the asset both for purposes of determining the amortization period and estimating cash flows for impairment purposes. Some constituents had asked the TRG to clarify whether including renewals or extension periods would be appropriate because of an inconsistency between ASC 340-40 and ASC 606. Specifically, the cost guidance indicates that costs capitalized could relate to goods or services to be transferred under "a specific anticipated contract"

[245] 18 July 2014 TRG meeting; agenda paper no. 4.

(e.g., goods or services to be provided under contract renewals and/or extensions) and that entities should follow the principles of ASC 606 for determining the transaction price. The guidance in ASC 606 (ASC 606-10-32-4) states that an entity should not anticipate that the contract will be "cancelled, renewed or modified" when determining the transaction price. In some instances, excluding renewals or extensions would have triggered an immediate impairment of a contract asset because the consideration an entity expects to receive would have not included anticipated cash flows from contract extension or renewal periods, but the entity would have capitalized contract costs on the basis that they would be recovered over the contract extension or renewal periods.

Note that when an entity determines the amount it expects to receive, the guidance on constraining estimates of variable consideration is also not considered. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price for the impairment test. While unconstrained, this amount must be reduced to reflect the customer's credit risk before it is used in the impairment test.

However, subject to the finalization of the FASB's May 2016 proposal, before recognizing an impairment loss on capitalized costs incurred to obtain or fulfill a contract, the entity will need to consider impairment losses recognized in accordance with another topic (e.g., ASC 330, ASC 985-20). After applying the impairment test to the capitalized costs in the scope of other topics and those in the scope of ASC 340-40, an entity includes the resulting carrying amounts in the carrying amount of the asset group or reporting unit for purposes of applying the guidance in ASC 360 or ASC 350.

Consistent with impairment guidance in other standards (e.g., ASC 360), entities following US GAAP will not be permitted to reverse impairment losses previously recognized.

UPDATE: In May 2016, the FASB proposed clarifying the inconsistency between ASC 340-40 and ASC 606 as discussed by the TRG (noted above) to make clear that when performing impairment testing an entity should consider expected contract renewals and extensions and include both the amount of consideration it already has received but has not recognized as revenue and the amount the entity expects to receive in the future. The FASB also proposed clarifying the interaction of the impairment testing in ASC 340-40 with other ASC topics (e.g., ASC 360). The proposal would clarify that the order of impairment testing is as discussed above. Comments were due 2 July 2016. To finalize this change, the FASB will need to issue a final ASU.

IASB differences

IFRS 15 permits the reversal of some or all of previous impairment losses if the estimates used to determine the asset's recoverable amount have changed.

10 Presentation and disclosure

The standard provides guidance on presentation and disclosure that applies to both public and nonpublic entities and provides some relief on disclosure requirements for nonpublic entities. As discussed in Section 1.2.1, the standard defines a public entity as one of the following:

- A PBE
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files or furnishes financial statements with the SEC

An entity that does not meet any of the criteria above is considered a nonpublic entity for purposes of this standard. The presentation and disclosure requirements for nonpublic entities are discussed separately below.

IASB differences

IFRS 15 does not differentiate between public and nonpublic entities.

10.1 Presentation requirements for contract assets and contract liabilities

The revenue model is based on the notion that a contract asset or contract liability is generated when either party to a contract performs, depending on the relationship between the entity's performance and the customer's payment. The guidance requires that an entity present these contract assets or contract liabilities in the statement of financial position (balance sheet) and is excerpted below:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Other Presentation Matters

606-10-45-1

When either party to a contract **has performed, an entity shall present the contract in the statement of financial position as a** contract asset **or a** contract liability**, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.**

606-10-45-2

If a **customer** pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

606-10-45-3

If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a **contract asset**, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with Topic 310 on receivables. An impairment of a contract asset shall be measured, presented, and disclosed in accordance with Topic 310 (see also paragraph 606-10-50-4(b)).

606-10-45-4

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Topic 310 and the corresponding amount of **revenue** recognized shall be presented as an expense (for example, as an impairment loss).

606-10-45-5

This guidance uses the terms *contract asset* and *contract liability* but does not prohibit an entity from using alternative descriptions in the statement of financial position for those items. If an entity uses an alternative description for a contract asset, the entity shall provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

When an entity satisfies a performance obligation by transferring a promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first (e.g., by prepaying its promised consideration), the entity has a contract liability.

Contract assets may represent conditional or unconditional rights to consideration. The right would be conditional, for example, when an entity first must satisfy another performance obligation in the contract before it is entitled to payment from the customer. If an entity has an unconditional right to receive consideration from the customer, the contract asset is accounted for as a receivable and presented separately from contract assets.[246] A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due.

In the Basis for Conclusions of ASU 2014-09,[247] the Board explains that in many cases an unconditional right to consideration (i.e., a receivable) arises when an entity satisfies a performance obligation, which could be before it invoices the customer (e.g., an unbilled receivable) if only the passage of time is required before payment of that consideration is due. It is also possible for an entity to have an unconditional right to consideration before it satisfies a performance obligation. In some industries, it is common for an entity to invoice its customers in advance of performance (and satisfaction of the performance obligation). For example, an entity that enters into a noncancellable contract requiring payment a month before the entity provides the goods or services would record a receivable and an offsetting contract liability on the date when payment is due.[248] In this situation, revenue is not recognized until goods or services are transferred to the customer.

[246] Paragraphs BC323 and BC324 of ASU 2014-09.

[247] Paragraph BC325 of ASU 2014-09.

[248] This conclusion (i.e., that a receivable is recorded when payment is due) is based on ASC 606-10-55-286 in Example 38 Case B (excerpted below), which is subject to a potential technical correction. See update box below.

In the Basis for Conclusions of ASU 2014-09,[249] the Board noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. Although both would be subject to credit risk, a contract asset also is subject to other risks (e.g., performance risk).

Under the standard, entities are not required to use the terms "contract asset" or "contract liability," but they must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (receivables) and conditional rights to receive consideration (contract assets). Additionally, entities with a classified balance sheet should consider the guidance in ASC 210 on classification of current assets and liabilities when determining whether their contract assets and contract liabilities should be presented as current or noncurrent.

The standard provides the following example of presentation of contract balances:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 38 — Contract Liability and Receivable

Case A — Cancellable Contract

606-10-55-284

On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. The entity receives cash of $1,000 on March 1, 20X9 (cash is received in advance of performance).

Cash	$ 1,000	
Contract Liability		$ 1,000

b. The entity satisfies the performance obligation on March 31, 20X9.

Contract Liability	$ 1,000	
Revenue		$ 1,000

Case B — Noncancellable Contract

606-10-55-285

The same facts as in Case A apply to Case B except that the contract is noncancellable. The following journal entries illustrate how the entity accounts for the contract:

a. The amount of consideration is due on January 31, 20X9 (which is when the entity recognizes a receivable because it has an unconditional right to consideration).

Receivable	$ 1,000	
Contract Liability		$ 1,000

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[249] Paragraph BC323 of ASU 2014-09.

b. The entity receives the cash on March 1, 20X9.

Cash	$ 1,000	
Receivable		$ 1,000

c. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$ 1,000	
Revenue		$ 1,000

606-10-55-286

If the entity issued the invoice before January 31, 20X9 (the due date of the consideration), the entity would not present the receivable and the contract liability on a gross basis in the statement of financial position because the entity does not yet have a right to consideration that is unconditional.

UPDATE: At the April 2016 FASB TRG meeting, the FASB staff provided an update on a question it had received from a stakeholder regarding Case B of Example 38. This example indicates that an entity could not record a receivable until the date the consideration for a noncancellable contract was due. However, the staff believes that ASC 606 requires any unconditional right to payment, such as when only the passage of time is required for payment, to be presented separately as a receivable. As such, the staff indicated it would likely recommend to the Board that it issue a technical correction for this example.

The standard includes another example of presentation of contract balances that illustrates when an entity has satisfied a performance obligation but does not have an unconditional right to payment and therefore recognizes a contract asset:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 39 — Contract Asset Recognized for the Entity's Performance

606-10-55-287

On January 1, 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for $1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of $1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

606-10-55-288

The entity identifies the promises to transfer Products A and B as performance obligations and allocates $400 to the performance obligation to transfer Product A and $600 to the performance obligation to transfer Product B on the basis of their relative standalone selling prices. The entity recognizes revenue for each respective performance obligation when control of the product transfers to the customer.

606-10-55-289

The entity satisfies the performance obligation to transfer Product A.

Contract asset	$ 400	
Revenue		$ 400

606-10-55-290

The entity satisfies the performance obligation to transfer Product B and to recognize the unconditional right to consideration.

Receivable	$ 1,000	
Contract asset		$ 400
Revenue		$ 600

After initial recognition, receivables and contract assets are subject to impairment assessments in accordance with ASC 310. In addition, if there is a difference between the initial measurement of the receivable under ASC 310 and the corresponding amount of revenue, that difference will be presented as an expense (i.e., as an impairment loss). This will be the case when the difference is attributable to customer credit risk rather than an implied price concession. Implied price concessions are deducted from the contract price to derive the transaction price, which is the amount recognized as revenue. Distinguishing between implied price concessions and expense due to customer credit risk will require judgment (see Section 5.2.1.1). Impairment losses resulting from contracts with customers are presented separately from losses on other contracts.

An entity could also have recorded other assets related to contracts with a customer (e.g., the incremental costs of obtaining the contract, other costs incurred that meet the criteria for capitalization). The guidance requires that any such assets be presented separately from contract assets and contract liabilities in the statement of financial position (assuming they are material). These amounts are also assessed for impairment separately.

Question 10-1

How should an entity determine the presentation of contract assets and liabilities for contracts that contain multiple performance obligations? [31 October 2014 TRG meeting; agenda paper no. 7]

Members of the TRG generally agreed that contract assets and liabilities should be determined at the contract level and not at the performance obligation level. That is, an entity would not separately recognize an asset or liability for each performance obligation within a contract but would aggregate them into a single contract asset or liability.

This question arose in part because, under the standard, the amount and timing of revenue recognition is determined based on progress toward complete satisfaction of *each* performance obligation. Therefore, some constituents questioned whether an entity could have a contract asset and a contract liability for a single contract when, for example, the entity has satisfied (or partially satisfied) one performance obligation in a contract for which consideration is not yet due but has received a prepayment for another unsatisfied performance obligation in the contract. Members of the TRG generally agreed that the discussion in the Basis for Conclusions of ASU 2014-09[250] was clear that contract asset or contract liability positions are determined for each contract on a net basis. This is because the rights and obligations in a contract with a customer are interdependent — the right to receive consideration from a

[250] Paragraph BC317 of ASU 2014-09.

customer depends on the entity's performance and similarly, the entity performs only as long as the customer continues to pay. The Board decided that those interdependencies are best reflected by accounting and presenting contract assets or liabilities on a net basis.

Question 10-2 **How should an entity determine the presentation of two or more contracts that have been required to be combined under the standard?** [31 October 2014 TRG meeting; agenda paper no. 7]

TRG members generally agreed that the contract asset or liability would be combined (i.e., presented net) for different contracts with the same customer (or a related party of the customer) if an entity is otherwise required to combine those contracts under the standard (see Section 3.3 for discussion of the criteria for combining contracts). When two or more contracts are required to be combined under the standard, the rights and obligations in the individual contracts are interdependent. Therefore, as discussed in Question 10-1, this interdependency is best reflected by combining the individual contracts as if they were a single contract. TRG members acknowledged that this analysis may be operationally difficult for some entities because their systems may capture data at the performance obligation level to comply with the recognition and measurement aspects of the standard.

Question 10-3 **When should an entity offset contract assets and liabilities against other balance sheet items? [31 October 2014 TRG meeting; agenda paper no. 7]**

TRG members generally agreed that because the standards do not provide offsetting guidance, entities will need to look to other guidance outside the revenue standard to determine whether offsetting is appropriate (e.g., the balance sheet offsetting guidance in ASC 210-20). For example, if an entity has a contract asset (or a receivable) and a contract liability from separate contracts with the same customer (that are not required to be combined under the standard), the entity will need to look to other guidance outside the revenue standard to determine whether offsetting is appropriate.

Question 10-4 **Is a refund liability a contract liability (and thus subject to the presentation and disclosure requirements of a contract liability)?**

We believe that a refund liability will not typically meet the definition of a contract liability. When an entity makes the conclusion that a refund liability is not a contract liability, it should present the refund liability separate from any contract liability (or asset) and it would not be subject to the disclosure requirements of ASC 606-10-50-8 and 50-10 discussed in Section 10.4.1 below.

When a customer pays consideration (or consideration is unconditionally due) and the entity has an obligation to transfer *goods or services* to the customer, the entity records a contract liability. When the entity expects to refund some or all of the *consideration* received (or receivable) from the customer, it records a refund liability. A refund liability generally does not represent an obligation to transfer goods or services in the future. Similar to receivables (which are considered a subset of contract assets), refund liabilities could be considered a subset of contract liabilities. We believe refund liabilities are also similar to receivables in that they should be extracted from the net contract position and presented separately (if material). This conclusion is consistent with the standard's specific requirement to present the corresponding asset for expected returns separately.

If an entity were to conclude, based on its specific facts and circumstances, that a refund liability did represent an obligation to transfer goods or services in the future, it would be a contract liability subject to the disclosure requirements in ASC 606-10-50-8 and 50-10. Additionally, in that situation, the entity would present a single net contract liability or asset (i.e., including the refund liability) determined at the contract level as discussed in Question 10-1.

Question 10-5 **How should an entity account for a contract asset that exists when a contract is modified if the modification is treated as the termination of an existing contract and the creation of a new contract?** [18 April 2016 FASB TRG meeting; agenda paper no. 51]

FASB TRG members generally agreed that a contract asset that exists when a contract is modified should be carried forward into the new contract if the modification is treated as the termination of an existing contract and the creation of a new contract.

Some stakeholders questioned the appropriate accounting for contract assets when this type of modification occurs because the termination of the old contract could indicate that any remaining balances associated with the old contract should be written off.

FASB TRG members generally agreed that it is appropriate to carry forward the related contract asset in such modifications because the asset relates to a right to consideration for goods and services that have already been transferred and are distinct from those to be transferred in the future. As such, the revenue recognized to date should not be reversed and the contract asset should continue to be realized as amounts become due from the customer and are presented as a receivable. The contract asset that remains on the entity's balance sheet at the date of modification would continue to be subject to evaluation for impairment in accordance with ASC 310.

While the FASB TRG members did not discuss this point, we believe a similar conclusion would be appropriate when accounting for an asset created under ASC 340-40, such as capitalized commissions, which exists immediately before a contract modification that is treated as if it were a termination of the existing contract and creation of a new contract. Refer to Question 9-9 in Section 9.3.1 for further discussion.

Question 10-6 **When should an entity record a receivable if it has not transferred a good or service but has an unconditional right to payment?**

ASC 606-10-45-4 states that a receivable is an entity's right to consideration that is unconditional. We believe it may be difficult to assert that the entity has an unconditional right to payment when it has not transferred a good or service.

An entity may enter into noncancellable contracts that provide unconditional rights to payment from the customer for services that the entity has not yet completed providing or services it will provide in the near future (e.g., advance billings related to a service or maintenance arrangement). When determining whether it is acceptable (or required) for an entity to record accounts receivable and contract liability, the contract terms and specific facts and circumstances supporting the existence of an unconditional right to payment should be evaluated. Factors to consider include:

- Does the vendor have a contractual (or legal) right to bill and receive payment from the customer for services being provided currently (and not yet completed) or being provided in the near future (e.g., advance billings related to a service or maintenance arrangement)?
- Is the advance billing consistent with the vendor's normal billing terms?
- Will the vendor commence performance within a relatively short timeframe of the invoice date?
- Is there more than one year between the advance billing and performance?

10.2 Other presentation considerations

The standard also changes the presentation requirements for products expected to be returned and for contracts that contain a significant financing component. Refer to Sections 5.4.1 and 5.5.2 for presentation considerations related to rights of return and significant financing components, respectively.

10.3 Annual disclosure requirements

In response to criticism that legacy revenue recognition disclosures are inadequate, the Board sought to create a comprehensive and coherent set of disclosures. It also described the overall objective of the disclosures, as it has done in other recent standards as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

606-10-50-1

The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

a. Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)

b. The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)

c. Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).

606-10-50-2

An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

Each of the disclosure topics in the above excerpt is discussed further below. Because the disclosure requirements differ for public and nonpublic entities, these topics are discussed in Section 10.4 for public entities and Section 10.5 for nonpublic entities. To assist entities in determining the required disclosures, Appendices D and E include excerpts of a US GAAP Disclosure Checklist for public and nonpublic entities, respectively.

As explained in the Basis for Conclusions of ASU 2014-09,[251] many preparers raised concerns when the Board was developing the standard that they would need to provide voluminous disclosures at a cost that might outweigh any potential benefits. In the final standard, the FASB clarified its disclosure objective and said the disclosures described in the guidance are not meant to be a checklist of minimum requirements. That is, entities do not have to include disclosures that are not relevant or not material to them.
In addition, the FASB decided to require qualitative disclosures instead of tabular reconciliations for certain information.

[251] Paragraphs BC327 and BC331 of ASU 2014-09.

How we see it

Entities should review their disclosures to determine whether they have met the standard's objective to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. For example, some entities may make large payments to customers that do not represent payment for a distinct good or service and therefore reduce the transaction price and affect the amount and timing of revenue recognized. Although there are no specific requirements in the standard to disclose balances related to consideration paid to a customer, an entity may need to disclose qualitative and/or quantitative information about those arrangements to meet the objective of the disclosure requirements in the standard if the amounts are material.

10.4 Disclosures for public entities

Under the standard, all applicable disclosures are required for and as of each reporting period for which a statement of comprehensive income and a statement of financial position are presented as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

606-10-50-3

Amounts disclosed are for each reporting period for which a statement of comprehensive income (statement of activities) is presented and as of each reporting period for which a statement of financial position is presented. An entity need not disclose information in accordance with the guidance in this Topic if it has provided the information in accordance with another Topic.

10.4.1 Contracts with customers

The majority of the standard's disclosure requirements relate to an entity's contracts with customers. These disclosures include disaggregation of revenue, information about contract asset and liability balances, and information about an entity's performance obligations. To provide context for the disclosures, the Board decided[252] to require entities to disclose the following amounts related to contracts with customers:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Contracts with Customers

606-10-50-4

An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other Topics:

a. **Revenue** recognized from **contracts** with **customers**, which the entity shall disclose separately from its other sources of revenue

[252] Paragraph BC332 of ASU 2014-09.

b. Any impairment losses recognized (in accordance with Topic 310 on receivables) on any receivables or **contract assets** arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses from other contracts.

ASC 606-10-5-4(a) requires an entity to disclose (or present in the statement of comprehensive income) the amount of revenue recognized from contracts with customers separately from other sources of revenue. For example, a large equipment manufacturer that both sells and leases its equipment should present (or disclose) amounts from these transactions separately.

ASC 606-10-5-4(b) also requires an entity to disclose impairment losses from contracts with customers separately from other impairment losses if they are not presented in the statement of comprehensive income separately. As noted in the Basis for Conclusions of ASU 2014-09,[253] the Board felt that separately disclosing the impairment losses on contracts with customers will provide the most relevant information to users of financial statements.

Disaggregation of revenue

Entities will be required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Entities are not required to disaggregate losses for uncollectible amounts. While the standard does not specify how revenue should be disaggregated, the implementation guidance suggests categories for entities to consider.

The implementation guidance indicates that the most appropriate categories for a particular entity will depend on its facts and circumstances, but an entity should consider how it disaggregates revenue in other communications (e.g., press releases, other public filings) when determining which categories are most relevant and useful.

The standard includes the following guidance on the required disaggregation of revenue disclosures:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Disaggregation of Revenue

606-10-50-5

An entity shall disaggregate **revenue** recognized from **contracts** with **customers** into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

606-10-50-6

In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

[253] Paragraph BC334 of ASU 2014-09.

Implementation Guidance and Illustrations

Disclosure of Disaggregated Revenue

606-10-55-89

Paragraph 606-10-50-5 requires an entity to disaggregate **revenue** from **contracts** with **customers** into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 606-10-50-5 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue.

606-10-55-90

When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following:

a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)

b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments

c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

606-10-55-91

Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)

b. Geographical region (for example, country or region)

c. Market or type of customer (for example, government and nongovernment customers)

d. Type of contract (for example, fixed-price and time-and-materials contracts)

e. Contract duration (for example, short-term and long-term contracts)

f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

As noted in the Basis for Conclusions of ASU 2014-09,[254] the Board decided not to prescribe a specific characteristic of revenue as the basis for disaggregation because it intended for entities to make this determination based on entity- and/or industry-specific factors that would be most meaningful for their businesses. The Board acknowledged that an entity may need to use more than one type of category to disaggregate its revenue.

[254] Paragraph BC336 of ASU 2014-09.

ASC 606-10-50-3 clarifies that an entity does not have to duplicate disclosures required by another standard. For example, an entity that provides disaggregated revenue disclosures as part of its segment disclosures does not have to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers are affected by economic factors and are presented on a basis consistent with US GAAP.

However, segment-related disclosures may not be sufficiently disaggregated to achieve the disclosure objectives of the revenue standard. The Board noted in the Basis for Conclusions of ASU 2014-09[255] that segment revenue disclosures may not always provide users of financial statements with enough information to help them understand the composition of revenue recognized in the period. If an entity provides disaggregated revenue disclosures in addition to segment disclosures, the standard requires an entity to explain the relationship between the disclosures. Users of the financial statements said this information is critical to their ability to understand not only the composition of revenue but also how revenue relates to other information provided in the segment disclosures. Entities can provide this information in a tabular or a narrative form.

The Board provided an example of disaggregation of revenue disclosures as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 41 — Disaggregation of Revenue — Quantitative Disclosure

606-10-55-296

An entity reports the following segments: consumer products, transportation, and energy, in accordance with Topic 280 on segment reporting. When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines, and timing of revenue recognition (that is, goods transferred at a point in time or services transferred over time).

606-10-55-297

The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 606-10-50-5, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation, and energy segments in accordance with paragraphs 606-10-50-6.

Segments	Consumer Products	Transportation	Energy	Total
Primary Geographical Markets				
North America	$ 990	$ 2,250	$ 5,250	$ 8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	$ 1,990	$ 3,260	$ 6,250	$ 11,500

[255] Paragraph BC340 of ASU 2014-09.

Major Goods/Service Lines				
Office Supplies	$ 600	–	–	600
Appliances	990	–	–	990
Clothing	400	–	–	400
Motorcycles	–	500	–	500
Automobiles	–	2,760	–	2,760
Solar panels	–	–	1,000	1,000
Power plant	–	–	5,250	5,250
	$ 1,990	$ 3,260	$ 6,250	$ 11,500
Timing of Revenue Recognition				
Goods transferred at a point in time	$ 1,990	$ 3,260	$ 1,000	$ 6,250
Services transferred over time	–	–	5,250	5,250
	$ 1,990	$ 3,260	$ 6,250	$ 11,500

Contract balances

The Board noted in the Basis for Conclusions of ASU 2014-09[256] that users of the financial statements need to understand the relationship between the revenue recognized and changes in the overall balances of an entity's total contract assets and liabilities during a particular reporting period. As a result, the Board included the following disclosure requirements for an entity's contract balances and changes in the balances:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Contract Balances

606-10-50-8

An entity shall disclose all of the following:

a. The opening and closing balances of receivables, **contract assets**, and **contract liabilities** from **contracts** with **customers**, if not otherwise separately presented or disclosed

b. **Revenue** recognized in the reporting period that was included in the contract liability balance at the beginning of the period

c. Revenue recognized in the reporting period from **performance obligations** satisfied (or partially satisfied) in previous periods (for example, changes in **transaction price**).

606-10-50-9

An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

[256] Paragraph BC341 of ASU 2014-09.

606-10-50-10

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

Entities are permitted to disclose information about contract balances and changes therein as they deem to be most appropriate, which could include a combination of tabular and narrative information. The FASB explained in the Basis for Conclusions of ASU 2014-09[257] that these disclosures are intended provide financial statement users with requested information on when contract assets are typically transferred to accounts receivable or collected as cash and when contract liabilities are recognized as revenue.

In addition to the disclosures on contract balances and changes, the standard requires entities to disclose the amount of revenue recognized in the period that relates to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods (e.g., due to a change in transaction price or in estimates related to the constraint on revenue recognized). As noted in the Basis for Conclusions of ASU 2014-09,[258] the Board said this information is not required elsewhere in the financial statements and will provide relevant information about the timing of revenue recognized that was not a result of performance in the current period.

The illustration below is an example of how an entity may fulfill these requirements:

Illustration 10-1: Contract asset and liability disclosures

Company A discloses trade receivables separately in the statement of financial position. To comply with the other disclosure requirements for contract assets and liabilities, Company A includes the following information in the notes to the financial statements:

	20X9	**20X8**	**20X7**
Contract asset	$ 1,500	$ 2,250	$ 1,800
Contract liability	(200)	(850)	(500)
Revenue recognized in the period from:			
Amounts included in contract liability at the beginning of the period	$ 650	$ 200	$ 100
Performance obligations satisfied in previous periods	$ 200	$ 125	$ 200

[257] Paragraph BC346 of ASU 2014-09.

[258] Paragraph BC347 of ASU 2014-09.

We receive payments from customers based on a billing schedule as established in our contracts. Contract asset relates to our right to consideration for our completed performance under the contract. Accounts receivable are recorded when the right to consideration becomes unconditional. Contract liability relates to payments received in advance of performance under the contract. Contract liabilities are recognized as revenue as (or when) we perform under the contract. In addition, contract asset decreased in 20X9 due to a contract asset impairment of $400 relating to the early cancellation of a contract with a customer.

How we see it

Disclosing contract assets and liabilities and the revenue recognized from changes in contract liabilities and performance obligations satisfied in previous periods will likely be a change in practice for most entities. They will need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information. For example, a sales- or usage-based royalty received by the entity in reporting periods after it delivers functional intellectual property represents revenue that the entity receives in subsequent periods that relates to a previously satisfied performance obligation and should be disclosed in accordance with ASC 606-10-50-8(c).

Performance obligations

To help users of financial statements analyze the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, the Board decided to require disclosures about an entity's performance obligations. As noted in the Basis for Conclusions of ASU 2014-09,[259] legacy GAAP requires entities to disclose their accounting policies for recognizing revenue, but users of financial statements have said that many entities provide a "boilerplate" description that doesn't explain how the policy relates to the contracts they enter into with customers. To address this criticism, the standard requires an entity to provide more descriptive information about its performance obligations.

A public entity is also required to disclose information about remaining performance obligations and the amount of the transaction price allocated to such obligations, including an explanation of when it expects to recognize the amount(s) in its interim and annual financial statements.

Both quantitative and qualitative information are required as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Performance Obligations

606-10-50-12

An entity shall disclose information about its **performance obligations** in **contracts** with **customers**, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

[259] Paragraph BC354 of ASU 2014-09.

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

Transaction Price Allocated to the Remaining Performance Obligations

606-10-50-13

An entity shall disclose the following information about its remaining **performance obligations**:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as **revenue** the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:

   1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

   2. By using qualitative information.

606-10-50-14

As a practical expedient, an entity need not disclose the information in paragraph 606-10-50-13 for a performance obligation if either of the following conditions is met:

a. The performance obligation is part of a **contract** that has an original expected duration of one year or less.

b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18.

606-10-50-15

An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 606-10-50-14 and whether any consideration from contracts with **customers** is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

In the Basis for Conclusions of ASU 2014-09,[260] the Board noted that many financial statement users commented that information about the amount and timing of revenue that an entity expects to recognize from its existing contracts would be useful in their analyses of revenue, especially for long-term contracts with significant unrecognized revenue. The Board also observed that a number of entities often

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[260] Paragraphs BC438 and BC349 of ASU 2014-09.

voluntarily disclose "backlog" information. However, this information typically is presented outside the financial statements and may not be comparable with what other entities disclose because there is no common definition of backlog.

As summarized in the Basis for Conclusions of ASU 2014-09,[261] the Board's goal in including the disclosure requirements in ASC 606-10-50-13 is to provide users of an entity's financial statements with additional information about the following:

- The amount and expected timing of revenue to be recognized from the remaining performance obligations in existing contracts
- Trends relating to the amount and expected timing of revenue to be recognized from the remaining performance obligations in existing contracts
- Risks associated with expected future revenue (e.g., some observe that revenue is more uncertain if an entity does not expect to satisfy a performance obligation until a much later date)
- The effect of changes in judgments or circumstances on an entity's revenue

This disclosure can be provided on either a quantitative basis (e.g., amounts to be recognized in given time bands, such as between one and two years and between two and three years) or by disclosing a mix of quantitative and qualitative information. In addition, this disclosure should only include amounts related to performance obligations in the current contract. For example, expected contract renewals that have not been executed and are not material rights are not performance obligations, so entities would not disclose amounts related to these renewals. However, if an entity concluded that expected contract renewals represented a material right to acquire goods or services in the future (and therefore is a separate performance obligation — see Section 4.6), the entity would include in its disclosure the consideration attributable to the material right for the options that have not yet been exercised (i.e., the unsatisfied performance obligation(s)).

The disclosure of the transaction price allocated to the remaining performance obligations does not include consideration that has been excluded from the transaction price. However, the standard requires entities to disclose qualitatively whether any consideration is not included in the transaction price and therefore not included in the disclosure of the remaining performance obligations (e.g., amounts of variable consideration that are constrained and excluded from the transaction price).

The FASB also provided a practical expedient under which an entity can decide to not disclose the amount of the remaining performance obligations for contracts with an original expected duration of less than one year or those for which the entity applies the "right to invoice" practical expedient in ASC 606-10-55-18. As explained in Section 7.1.4, the right to invoice practical expedient permits an entity that is recognizing revenue over time to recognize revenue as invoiced if the entity's right to payment is in an amount that corresponds directly with the value to the customer of the entity's performance to date. For example, an entity may not be required to make the disclosure for a three-year service contract under which it has a right to invoice the customer a fixed amount for each hour of service provided, provided that fixed amount reflects the value to the customer. An entity that uses this disclosure practical expedient will be required to disclose that fact.

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[261] Paragraph BC350 of ASU 2014-09.

UPDATE: The FASB proposed another practical expedient that would allow an entity not to disclose variable consideration allocated to performance obligations related to either: (1) sales- or usage-based royalties on licenses of intellectual property or (2) variable consideration allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation when certain criteria are met. Comments were due 2 July 2016. To finalize this change, the FASB will need to issue a final ASU.

The standard provides the following examples of various scenarios for these required disclosures:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 42 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations

606-10-55-298

On June 30, 20X7, an entity enters into three contracts (Contracts A, B, and C) with separate customers to provide services. Each contract has a two-year noncancellable term. The entity considers the guidance in paragraphs 606-10-50-13 through 50-15 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at December 31, 20X7.

Contract A

606-10-55-299

Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of $25.

606-10-55-300

Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph 606-10-55-18. Consequently, no disclosure is necessary if the entity elects to apply the practical expedient in paragraph 606-10-50-14(b).

Contract B

606-10-55-301

Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of $400 per month for both services. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

606-10-55-302

The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The information for Contract B included in the overall disclosure is as follows.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$4,800[(a)]	$2,400[(b)]	$7,200

(a) $4,800 = $400 x 12 months

(b) $2,400 = $400 x 6 months

Contract C

606-10-55-303

Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of $100 per month plus a one-time variable consideration payment ranging from $0 — $1,000 corresponding to a one-time regulatory review and certification of the customer's facility (that is, a performance bonus). The entity estimates that it will be entitled to $750 of the variable consideration. On the basis of the entity's assessment of the factors in paragraph 606-10-32-12, the entity includes its estimate of $750 of variable consideration in the transaction price because it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

606-10-55-304

The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The entity also includes a qualitative discussion about any significant variable consideration that is not included in the disclosure. The information for Contract C included in the overall disclosure is as follows.

Example disclosure:

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$1,575[(a)]	$788[(b)]	$2,363

(a) Transaction price = $3,150 ($100 x 24 months + $750 variable consideration) recognized evenly over 24 months at $1,575 per year

(b) $1,575 ÷ 2 = $788 (that is, for 6 months of the year)

606-10-55-305

In addition, in accordance with paragraph 606-10-50-15, the entity discloses qualitatively that part of the performance bonus has been excluded from the disclosure because it was not included in the transaction price. That part of the performance bonus was excluded from the transaction price in accordance with the guidance on constraining estimates of variable consideration.

The standard also provides an example of how an entity would make the disclosure required by ASC 606-10-50-13(b) using qualitative information (as opposed to quantitatively using time bands) as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 43 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations — Qualitative Disclosure

606-10-55-306

On January 1, 20X2, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of $10 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of December 31, 20X2, the entity has recognized $3.2 million of revenue. The entity estimates that construction will be completed in 20X3 but it is possible that the project will be completed in the first half of 20X4.

606-10-55-307

At December 31, 20X2, the entity discloses the amount of the transaction price that has not yet been recognized as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognize that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

As of December 31, 20X2, the aggregate amount of the transaction price allocated to the remaining performance obligation is $6.8 million, and the entity will recognize this revenue as the building is completed, which is expected to occur over the next 12-18 months.

10.4.2 Significant judgments

The guidance requires disclosure of significant accounting estimates and judgments made in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Significant Judgments in the Application of the Guidance in this Topic

606-10-50-17

An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect the determination of the amount and timing of **revenue** from **contracts** with **customers**. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

a. The timing of satisfaction of **performance obligations** (see paragraphs 606-10-50-18 through 50-19)

b. The **transaction price** and the amounts allocated to performance obligations (see paragraph 606-10-50-20).

Legacy GAAP has general guidance requiring disclosures about significant accounting estimates and judgments made by an entity. Because of the importance placed on revenue by users of financial statements, as noted in the Basis for Conclusion of ASU 2014-09,[262] the Board decided to require specific disclosures about the estimates used and the judgments made in determining the amount and timing of revenue recognition. These requirements exceed the requirements in legacy GAAP on significant accounting estimates and are discussed in more detail below.

Determining the timing of satisfaction of performance obligations

The guidance requires entities to provide disclosures about the significant judgments made in determining the timing of satisfaction of performance obligations. The disclosure requirements for performance obligations that are satisfied over time differ from those satisfied at a point in time, but the objective is similar — to disclose the judgments made in determining the timing of revenue recognition. Public entities must disclose the following information:

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[262] Paragraph BC355 of ASU 2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Timing of Satisfaction of Performance Obligations

606-10-50-18

For **performance obligations** that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize **revenue** (for example, a description of the output methods or input methods used and how those methods are applied)

b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

606-10-50-19

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a **customer** obtains control of promised goods or services.

When an entity has determined that a performance obligation is satisfied over time, the standard requires the entity to select a single revenue recognition method for each performance obligation that depicts the entity's performance in transferring the goods or services. Entities must disclose the method used to recognize revenue.

For example, assume an entity enters into a contract to refurbish a multilevel building for a customer, and the work is expected to take two years. The entity has concluded the promised refurbishment service is a single performance obligation satisfied over time, and it decides to measure progress based on costs it incurs. The entity discloses the method used, how it is applied to the contract and why the method selected provides a faithful depiction of the transfer of goods or services.

When an entity has determined that a performance obligation is satisfied at a point in time, the standard requires the entity to disclose the significant judgments made in evaluating when the customer obtains control of the promised goods or services. For example, an entity will consider the indicators of the transfer of control included in ASC 606-10-25-30 to determine when control transfers and disclose significant judgments made in reaching that conclusion.

Determining the transaction price and the amounts allocated to performance obligations

Entities often exercise significant judgment when estimating the transaction prices of their contracts, especially when those estimates involve variable consideration.

Further, significant judgment may be required when allocating the transaction price, including estimating standalone selling prices. For example, FASB TRG[263] members generally agreed that entities will have to exercise significant judgment to determine whether a customer option gives rise to a material right (see Section 4.6) and estimating the standalone selling price for those material rights. Because of the importance placed on revenue by financial statement users, the Board concluded[264] that it was important to require public entities to disclose qualitative information in their annual financial statements about the methods, inputs and assumptions used in making these judgments, as follows:

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[263] 18 April 2016 FASB TRG meeting; agenda paper no. 54.

[264] Paragraph BC355 of ASU 2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Transaction Price and the Amounts Allocated to Performance Obligations

606-10-50-20

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the **transaction price**, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration

b. Assessing whether an estimate of variable consideration is constrained

c. Allocating the transaction price, including estimating **standalone selling prices** of promised goods or services and allocating discounts and variable consideration to a specific part of the **contract** (if applicable)

d. Measuring obligations for returns, refunds, and other similar obligations.

How we see it

Disclosing information about the methods, inputs and assumptions they use to determine and allocate the transaction price will be a change in practice for some entities. Entities with diverse contracts will need to make sure they have the processes and procedures in place to capture all of the different methods, inputs and assumptions used.

10.4.3 Assets recognized for the costs to obtain or fulfill a contract

In addition to the guidance in ASC 606, the FASB added ASC 340-40 to codify the guidance on other assets and deferred costs relating to contracts with customers. As discussed in Section 9.3, this guidance specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The guidance requires entities to disclose information about the assets recognized to help users understand the types of costs recognized as assets and how those assets are subsequently amortized or impaired. These disclosures are:

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Disclosure

Assets Recognized from the Costs to Obtain or Fulfill a Contract with a Customer

340-40-50-1

Consistent with the overall disclosure objective in paragraph 606-10-50-1 and the guidance in paragraphs 606-10-50-2 through 50-3, an entity shall provide the following disclosures of assets recognized from the costs to obtain or fulfill a **contract** with a **customer** in accordance with paragraphs 340-40-25-1 or 340-40-25-5.

340-40-50-2

An entity shall describe both of the following:

a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5)

b. The method it uses to determine the amortization for each reporting period.

340-40-50-3

An entity shall describe both of the following:

a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)

b. The amount of amortization and any impairment losses recognized in the reporting period.

Entities will be required to disclose the judgments made in determining the amount of costs that were incurred to obtain or fulfill contracts with customers that meet the criteria for capitalization as well as the method the entity uses to amortize the assets recognized. For example, for costs to obtain a contract, an entity that capitalizes commission costs upon the signing of each contract will need to describe the judgments used to determine the commission costs that qualified as costs incurred to obtain a contract with a customer as well as the determination of the amortization period.

10.4.4 Practical expedients

The standard allows entities to use several practical expedients. The standard requires public entities to disclose their use of two practical expedients — the practical expedient associated with the determination of whether a significant financing component exists (see Section 5.5) and the expedient for recording an immediate expense for certain incremental costs of obtaining a contract with a customer (see Section 9.3.1) — as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Practical Expedients

606-10-50-22

If an entity elects to use the practical expedient in either paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a **contract**), the entity shall disclose that fact.

Other Assets and Deferred Costs — Contracts with Customers

Disclosure

Assets Recognized from the Costs to Obtain or Fulfill a Contract with a Customer

340-40-50-5

If an entity elects to use the practical expedient in paragraph 340-40-25-4 on the incremental costs of obtaining a contract, the entity shall disclose that fact.

10.5 Disclosures for nonpublic entities

Under the standard, nonpublic entities can choose to provide all of the disclosures required for public entities or to provide reduced disclosures. As noted in the Basis for Conclusions of ASU 2014-09,[265] the FASB decided that some of the disclosure requirements should differ for nonpublic entities, primarily because the costs of providing them outweigh the benefits. The FASB also noted that users of nonpublic entity financial statements often have access to supplemental revenue information directly from management. The following is a discussion highlighting the reduced disclosure requirements for nonpublic entities that select this option.

10.5.1 Contracts with customers

Disclosures related to an entity's contracts with customers will likely make up a significant portion of the required disclosures under the standard. These disclosures include disaggregation of revenue, contract asset and liability balances, and information about an entity's performance obligations. To provide context for the disclosures, the Board decided[266] to require entities to disclose the following amounts related to contracts with customers:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Contracts with Customers

606-10-50-4

An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other Topics:

a. **Revenue** recognized from **contracts** with **customers**, which the entity shall disclose separately from its other sources of revenue

b. Any impairment losses recognized (in accordance with Topic 310 on receivables) on any receivables or **contract assets** arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses from other contracts.

Disaggregation of revenue

Nonpublic entities are required to provide, at a minimum, quantitative disclosures about revenue, disaggregated based on the timing of transfer of goods or services (e.g., revenue recognized at a point in time and revenue recognized over time) in their interim and annual financial statements, as applicable. Nonpublic entities may include the additional information described in ASC 606-10-50-5 through 50-6, but this information is not required. However, if a nonpublic entity decides not to provide that information, the FASB decided the entity should at a minimum disclose qualitative information to address how economic factors (e.g., type of customer, geographical location of customers, type of contract) affect revenue and cash flows as specified in ASC 606-10-50-7 below:

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[265] Paragraph BC506 of ASU 2014-09.
[266] Paragraph BC332 of ASU 2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Disaggregation of Revenue

606-10-50-5

An entity shall disaggregate **revenue** recognized from **contracts** with **customers** into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

606-10-50-6

In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

606-10-50-7

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission (SEC), may elect not to apply the quantitative disaggregation disclosure guidance in paragraphs 606-10-50-5 through 50-6 and 606-10-55-89 through 55-91. If an entity elects not to provide those disclosures, the entity shall disclose, at a minimum, revenue disaggregated according to the timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time) and qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Contract balances

The FASB noted in the Basis for Conclusions of ASU 2014-09[267] that it believes users of the financial statements need to understand the relationship between revenue recognized and changes in the overall balances of an entity's total contract assets and liabilities during a particular reporting period. The FASB also noted[268] that nonpublic entities could make these disclosures without incurring significant costs because they would have to calculate those balances to apply the revenue guidance. As a result, the standard requires nonpublic entities to disclose the opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers (ASC 606-10-50-8(a)) if not otherwise separately presented or disclosed. This requirement likely will result in new disclosures for most nonpublic entities. The other contract balance disclosures described below are permitted but not required for nonpublic entities:

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[267] Paragraph BC341 of ASU 2014-09.

[268] Paragraph BC512 of ASU-2014-09.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Contract Balances

606-10-50-8

An entity shall disclose all of the following:

a. The opening and closing balances of receivables, **contract assets**, and **contract liabilities** from **contracts** with **customers**, if not otherwise separately presented or disclosed

b. **Revenue** recognized in the reporting period that was included in the contract liability balance at the beginning of the period

c. Revenue recognized in the reporting period from **performance obligations** satisfied (or partially satisfied) in previous periods (for example, changes in **transaction price**).

606-10-50-9

An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

606-10-50-10

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

606-10-50-11

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide any or all of the disclosures in paragraphs 606-10-50-8 through 50-10. However, if an entity elects not to provide the disclosures in paragraphs 606-10-50-8 through 50-10, the entity shall provide the disclosure in paragraph 606-10-50-8(a), which requires the disclosure of the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed.

Performance obligations

To help users of financial statements analyze the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, the Board decided to require disclosures about an entity's performance obligations. Nonpublic entities are required to disclose when they typically satisfy their performance obligations, the significant payment terms, the nature of the goods or services the entity has promised to transfer, any obligations for returns, refunds and any warranty provisions, as detailed in ASC 606-10-50-12. Nonpublic entities may decide to provide the disclosures for the transaction price allocated to remaining performance obligations detailed below in ASC 606-10-50-13 through 50-15, but these disclosures are not required:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Performance Obligations

606-10-50-12

An entity shall disclose information about its **performance obligations** in **contracts** with **customers**, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

Transaction Price Allocated to the Remaining Performance Obligations

606-10-50-13

An entity shall disclose the following information about its remaining **performance obligations**:

a. The aggregate amount of the **transaction price** allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as **revenue** the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:

   1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

   2. By using qualitative information.

606-10-50-14

As a practical expedient, an entity need not disclose the information in paragraph 606-10-50-13 for a performance obligation if either of the following conditions is met:

a. The performance obligation is part of a **contract** that has an original expected duration of one year or less.

b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18.

606-10-50-15

An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 606-10-50-14 and whether any consideration from contracts with **customers** is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

606-10-50-16

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide the disclosures in paragraphs 606-10-50-13 through 50-15.

10.5.2 Significant judgments

The guidance also requires the disclosure of significant accounting estimates and judgments made in determining the transaction price, allocating the transaction price to performance obligations and determining the timing of satisfaction of performance obligations. These disclosure requirements exceed the requirements in the general guidance on significant accounting estimates required under legacy GAAP and are as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Significant Judgments in the Application of the Guidance in this Topic

606-10-50-17

An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect the determination of the amount and timing of **revenue** from **contracts** with **customers**. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

a. The timing of satisfaction of **performance obligations** (see paragraphs 606-10-50-18 through 50-19)

b. The **transaction price** and the amounts allocated to performance obligations (see paragraph 606-10-50-20).

Determining the timing of satisfaction of performance obligations

The guidance requires nonpublic entities to provide disclosures about the significant judgments made in determining the timing of satisfaction of performance obligations. For performance obligations that are satisfied over time, nonpublic entities must disclose the methods used to recognize revenue (e.g., a description of the output method, a description of the input method, how those methods are applied

(ASC 606-10-50-18(a))). A nonpublic entity may also provide an explanation of why the method used to recognize revenue over time provides a faithful depiction of the transfer of goods or services and the significant judgments made in evaluating when control transfers at a point in time, but those disclosures, as follow, are not required:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Timing of Satisfaction of Performance Obligations

606-10-50-18

For **performance obligations** that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize **revenue** (for example, a description of the output methods or input methods used and how those methods are applied)

b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

606-10-50-19

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a **customer** obtains control of promised goods or services.

Determining the transaction price and the amounts allocated to performance obligations

The standard requires nonpublic entities to disclose qualitative information about the methods, inputs and assumptions used for assessing whether an estimate of variable consideration is constrained (ASC 606-10-50-20(b)).

In addition to the required disclosures, nonpublic entities may provide any or all of the following disclosures about determining the transaction price and the amounts allocated to performance obligations:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Transaction Price and the Amounts Allocated to Performance Obligations

606-10-50-20

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the **transaction price**, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration

b. Assessing whether an estimate of variable consideration is constrained

c. Allocating the transaction price, including estimating **standalone selling prices** of promised goods or services and allocating discounts and variable consideration to a specific part of the **contract** (if applicable)

d. Measuring obligations for returns, refunds, and other similar obligations.

606-10-50-21

An entity except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide any or all of the following disclosures:

a. Paragraph 606-10-50-18(b), which states that an entity shall disclose, for **performance obligations** satisfied over time, an explanation of why the methods used to recognize **revenue** provide a faithful depiction of the transfer of goods or services to a **customer**

b. Paragraph 606-10-50-19, which states that an entity shall disclose, for performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services

c. Paragraph 606-10-50-20, which states that an entity shall disclose the methods, inputs, and assumptions used to determine the transaction price and to allocate the transaction price. However, if an entity elects not to provide the disclosures in paragraph 606-10-50-20, the entity shall provide the disclosure in paragraph 606-10-50-20(b), which states that an entity shall disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

10.5.3 Assets recognized for the costs to obtain or fulfill a contract

Nonpublic entities may disclose information about assets recognized from the costs to obtain or fulfill a contract, but this information is not required. The information is intended to help users understand the types of costs recognized as assets and how those assets are subsequently amortized or impaired. Refer to Section 10.4.3 above for a discussion of the requirements for public entities. The exception for nonpublic entities is detailed below:

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Disclosure

Assets Recognized from the Costs to Obtain or Fulfill a Contract with a Customer

340-40-50-4

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, may elect not to provide the disclosures in paragraphs 340-40-50-2 through 50-3.

10.5.4 Practical expedients

The standard allows entities to use several practical expedients and specifically requires disclosure of a public entity's use of two of those expedients (see Section 10.4.4). However, a nonpublic entity is not required to do so as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Practical Expedients

606-10-50-23

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide the disclosures in paragraph 606-10-50-22.

Other Assets and Deferred Costs — Contracts with Customers

Disclosure

Practical Expedients

340-40-50-6

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, may elect not to provide the disclosure in paragraph 340-40-50-5.

As noted in the Basis for Conclusions of ASU 2014-09,[269] the FASB decided that a nonpublic entity may decide not to disclose that it is using these practical expedients in part because the public entity disclosure requirements are generally consistent with the requirements under ASC 235 (e.g., an entity should disclose its selections from acceptable accounting alternatives), which a nonpublic entity will follow and determine if the information should be disclosed.

10.6 Interim disclosure requirements

ASU 2014-09 (through consequential amendments to ASC 270) expands the disclosure requirements for interim financial statements as described below:

Excerpt from Accounting Standards Codification

Interim Reporting

Disclosure

Disclosure of Summarized Interim Financial Data by Publicly Traded Companies

270-10-50-1A

Consistent with paragraph 270-10-50-1, a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, shall disclose all of the following information about **revenue** from **contracts** with **customers** consistent with the guidance in Topic 606:

a. A disaggregation of revenue for the period, see paragraphs 606-10-50-5 through 50-6 and paragraphs 606-10-55-89 through 55-91.

[269] Paragraph BC516 of ASU 2014-09.

b. The opening and closing balances of receivables, **contract assets**, and **contract liabilities** from contracts with customers (if not otherwise separately presented or disclosed), see paragraph 606-10-50-8(a).

c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period, see paragraph 606-10-50-8(b).

d. Revenue recognized in the reporting period from **performance obligations** satisfied (or partially satisfied) in previous periods (for example, changes in **transaction price**), see paragraph 606-10-50-8(c).

e. Information about the entity's remaining performance obligations as of the end of the reporting period, see paragraphs 606-10-50-13 through 50-15.

The FASB amended ASC 270 to require the same quantitative disclosures about revenue in interim financial statements as in the annual financial statements. While ASC 270 already required entities to disclose information about changes in financial position and performance since the last annual reporting period, the FASB decided that specifying the revenue-related disclosures required in entities' interim financial statements would reduce the risk that entities might reach different conclusions about what represents a significant change and how information about that change should be presented in interim financial statements. In reaching this conclusion, the FASB indicated in the Basis for Conclusions of ASU 2014-09[270] that an entity has much of the information required for the disclosures on an interim basis readily available, and disclosing that information may not raise costs significantly.

IASB differences

The interim disclosure requirements for US GAAP reporting entities differ from the requirements for IFRS reporting entities. While the IASB amended its interim reporting standard, IAS 34, to require disaggregated revenue information, it decided not to require IFRS preparers to make any of the other annual disclosures under IFRS 15 on an interim basis that the FASB requires for US GAAP preparers.

10.7 Transition disclosure requirements

The revenue standard requires retrospective application. However, the Board decided to allow either full retrospective adoption in which the standard is applied to all of the periods presented or a modified retrospective adoption. The transition disclosure requirements will differ for entities depending on the transition method selected. Refer to Section 1.3 for additional discussion on transition, including the disclosure requirements.

[270] Paragraph BC361 of ASU 2014-09.

11 Gains and losses from the derecognition of nonfinancial assets

ASU 2014-09 created ASC 610-20 to account for any gain or loss resulting from the sale of nonfinancial assets within the scope of ASC 350 or ASC 360 that are not an output of an entity's ordinary activities. This includes the sale of intangible assets and property, plant and equipment, including real estate.

ASC 610-20 does not contain guidance that goes beyond ASC 606. Instead, it instructs entities to apply certain recognition and measurement principles of ASC 606. Thus, the accounting for contracts that include the sale of a nonfinancial asset to a noncustomer and to a customer generally will be consistent, except for financial statement presentation and disclosure (i.e., entities that sell nonfinancial assets to noncustomers will follow the guidance in ASC 360-10 for presenting a gain or loss). The FASB noted in the Basis for Conclusions of ASU 2014-09[271] that there is economically little difference between the sale of real estate that is, or is not, an output of an entity's ordinary activities. Therefore, the Board determined that the only difference in the treatment of these transactions should be the presentation in the statement of comprehensive income (i.e., revenue and expense when the sale is to a customer and net gain or loss when the sale is to a noncustomer).

ASC 610-20 also requires entities to apply certain recognition and measurement principles in ASC 606 to the transfer of a subsidiary (or a group of assets) that is, in substance, a nonfinancial asset within the scope of ASC 350 or ASC 360. However, the transfer of a subsidiary (or a group of assets) that is a business and does not also qualify as an in substance nonfinancial asset will continue to be accounted for in accordance with legacy derecognition guidance.[272]

UPDATE: In June 2016, the FASB proposed making ASC 610-20 the default recognition guidance for nonfinancial assets, not just those in the scope of ASC 350 or ASC 360, when no other guidance applies. Comments were due 5 August 2016. To finalize this change, the FASB will need to issue a final ASU.

11.1 Scope of ASC 610-20

An entity must determine whether a sale of nonfinancial assets is within the scope of ASC 606, ASC 610-20 or ASC 810.[273] As described below, ASC 610-20 applies to gains or losses on sales to noncustomers of nonfinancial assets or in substance nonfinancial assets that are within the scope of ASC 350 or ASC 360, with certain limited exceptions:

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[271] Paragraph BC497 of ASU 2014-09.

[272] Generally, such transactions are within the scope of ASC 810. However, certain types of transactions (e.g., spinoffs, split-offs, conveyances of oil and gas mineral rights) are excluded from the scope of ASC 810, as stated in ASC 810-10-40-3A and ASC 810-10-40-5, because they are addressed by other guidance.

[273] As noted in the previous footnote, other guidance may also apply for certain types of transactions.

Excerpt from Accounting Standards Codification

Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets

Overview and Background

610-20-05-1

This Subtopic provides guidance on a gain or loss recognized upon the derecognition of a nonfinancial asset within the scope of Topic 350 on intangibles and Topic 360 on property, plant, and equipment (including in substance nonfinancial assets) if those assets are not in a contract with a customer within the scope of Topic 606 on revenue from contracts with customers.

Scope and Scope Exceptions

610-20-15-1

The guidance in this Subtopic applies to all entities.

610-20-15-2

The guidance in this Subtopic applies to the following events and transactions:

a. The gain or loss recognized upon the derecognition of a nonfinancial asset within the scope of Topic 350 on intangibles or Topic 360 on property, plant, and equipment, unless the entity sells or transfers the nonfinancial asset in a contract with a customer.

b. The gain or loss recognized upon the transfer of financial assets that are in substance nonfinancial assets within the scope of Topic 350 or Topic 360 (for example, the sale of a subsidiary that only consists of an asset [for example, a machine or piece of equipment]).

610-20-15-3

The guidance in this Subtopic does not apply to the following:

a. The derecognition of a nonfinancial asset, including an in substance nonfinancial asset, in a contract with a customer, see Topic 606 on revenue from contracts with customers

b. The derecognition of a subsidiary or group of assets that constitutes a business or nonprofit activity (excluding an in substance nonfinancial asset), see Section 810-10-40 on consolidation

c. Real estate sale-leaseback transactions, see Subtopics 360-20 and 840-40 on leases

d. A conveyance of oil and gas mineral rights, see Subtopic 932-360 on extractive activities

e. A transfer of a nonfinancial asset to another entity in exchange for a noncontrolling ownership interest in that entity, see the guidance on exchanges of a nonfinancial asset for a noncontrolling ownership interest in Section 845-10-30.

The FASB amended the derecognition guidance for sales or transfers of intangibles and property, plant and equipment within the scope of ASC 350-10 and ASC 360-10, respectively. This amended guidance states that sales of nonfinancial assets, including in substance nonfinancial assets, should be accounted for using the guidance in ASC 610-20, unless the contract is with a customer (i.e., a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration). If the contract is with a customer, ASC 606 will apply.

In certain circumstances, neither ASC 606 nor ASC 610-20 will be applied when derecognizing a nonfinancial asset. Instead, the sale of nonfinancial assets in a subsidiary or group of assets that meets all of the following requirements will be accounted for in accordance with the derecognition guidance in ASC 810:[274]

- The nonfinancial assets are not being sold to a customer (i.e., they are not outputs of the entity's ordinary activities)
- The nonfinancial assets in a subsidiary or group of assets meet the definition of a business
- The nonfinancial assets in a subsidiary or group of assets are not in substance nonfinancial assets (e.g., because the group of assets or subsidiary also contains significant financial assets)
- No other scope exceptions in ASC 810-10 apply

The following table summarizes the appropriate derecognition guidance to apply for common transactions:

ASC topic	When applied?	Possible transactions
ASC 606, *Revenue from Contracts with Customers*	Sales to customers of nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a business	Sales of heavy equipment by the manufacturer
ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*	Sales or transfers to noncustomers of nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a business	Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by non-real estate entities
ASC 810-10, *Consolidation — Overall*	Sales or transfers to noncustomers of businesses that also are not in substance nonfinancial assets. In addition, ASC 810-10 is applied to the sale or transfer of a subsidiary if no other GAAP applies.	Sales of a portfolio of hotels, including significant value related to existing receivables, leases to retail tenants and the hotels' brand name (i.e., nonfinancial assets and financial assets that together meet the definition of a business)

UPDATE: In June 2016, the FASB proposed excluding all businesses from the scope of ASC 610-20. Under the proposal, an entity would not need to evaluate whether a business is an in substance nonfinancial asset. This proposal is part of the second phase of the FASB's definition of a business project. Comments were due 5 August 2016. To finalize this change, the FASB will need to issue a final ASU. In the first phase of the project, the FASB proposed limiting the type of transactions that would qualify as a business, so many in substance nonfinancial assets would not meet the definition of a business.

11.1.1 Definition of a customer

ASC 610-20 and ASC 606 define a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from legacy guidance. CON 6 refers to ordinary activities as an entity's "ongoing major or central operations."

For example, a heavy equipment manufacturer sells equipment as an output of its ordinary activities. The sale of a home by a homebuilder is also an ordinary activity. In contrast, an entity that sells equipment it previously used in its manufacturing operations to another entity likely would conclude that its decision to dispose of an operating asset is not an output of its ordinary activities and, therefore, does not represent a contract with a customer.

[274] ASC 810-10-45-21A.

If an entity sells a nonfinancial asset to a party that is a customer in other transactions (i.e., the party is purchasing goods or services from the entity that are the output of the entity's ordinary activities), we believe the purchasing party will be considered a customer for the transactions involving the goods or services but not for the sale of the nonfinancial asset.

11.1.2 In substance nonfinancial assets

The term "in substance nonfinancial asset" is a new concept used in ASC 610-20-15-2(b) that is not defined in the standard or elsewhere in US GAAP. In that paragraph, the example of an in substance nonfinancial asset is a legal entity that holds only nonfinancial assets. The owner that holds shares (i.e., a financial asset) in the entity would consider the interest an "in substance" nonfinancial asset because the legal entity owns only nonfinancial assets (e.g., real estate). Because the economics of a sale by the owner of its interest or the underlying nonfinancial assets would be similar, the FASB decided that these ownership interests should be accounted for as nonfinancial assets.

Entities may find it easy to identify an in substance nonfinancial asset if, for example, a single nonfinancial asset is held by a legal entity. However, this assessment may be more difficult and may require significant judgment if the legal entity holds both financial and nonfinancial assets or nonfinancial assets that are outside the scope of ASC 350 or ASC 360 (i.e., nonfinancial assets that are not intangibles or property, plant and equipment, such as inventory). The fact that an entity is a business does not mean it is not an in substance nonfinancial asset.

UPDATE: In June 2016, the FASB proposed clarifying that assets within a group of assets or a subsidiary that is not a business are in substance nonfinancial assets if substantially all of the fair value of the assets is concentrated in nonfinancial assets. When comparing the fair value of the nonfinancial assets to total assets, cash and cash equivalents should be excluded from total assets. The Board also proposed that the transfer of a subsidiary (that is not a business or an in substance nonfinancial asset) for which the substance of the transaction is not subject to other GAAP (e.g., ASC 860 on financial assets) would continue to be accounted for under ASC 810. For example, a subsidiary may hold a significant amount of financial assets (e.g., securities) and nonfinancial assets (e.g., a building and equipment) but not meet the definition of a business or an in substance nonfinancial asset (because of the significance of the financial assets). In this case, the transfer of the subsidiary would be accounted for under ASC 810 if it was not subject to other GAAP. Comments were due 5 August 2016. To finalize this change, the FASB will need to issue a final ASU.

11.1.3 Real estate sale-leaseback transactions

The guidance on sales of real estate that are part of a sale-leaseback transaction within the scope of ASC 840-40 was retained in ASC 360-20. Therefore, these transactions will be accounted for under ASC 360-20 and not under ASC 610-20. A number of amendments were made to narrow the scope of ASC 360-20, and the FASB stated[275] that entities should not analogize to the retained guidance when evaluating any transaction that is not a sale-leaseback.

Sales of non-real estate that are part of a sale-leaseback transaction are not specifically scoped out of ASC 610-20 until an entity adopts the new leases standard, as described below. As a result, they will be accounted for under ASC 610-20.

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[275] Paragraph 63 of the *Conforming Amendments Related to Revenue from Contracts with Customers: Amendments to the Accounting Standards Codification*.

The FASB issued ASU 2016-02 (largely codified in ASC 842) in February 2016, which provides new guidance for sale-leaseback transactions (referred to as sale and leaseback transactions in ASC 842) that will replace the guidance in ASC 360-20 and ASC 840-40. Upon adoption of ASC 842, an entity will not apply ASC 610-20 to sale-leaseback transactions. In many cases, applying ASC 842 will not result in a different outcome from ASC 610-20 because ASC 842 requires entities to apply certain guidance in ASC 606 (e.g., existence of a contract, determining when an entity satisfies a performance obligation by transferring control of an asset). However, ASC 842 provides additional guidance on whether a sale occurs, so some differences may result. The guidance in ASU 2016-02 is effective for public entities for annual periods beginning after 15 December 2018 but can be early adopted. Nonpublic entities will have an additional year to adopt ASU 2016-02.

11.1.4 Nonmonetary exchanges involving a noncontrolling ownership interest in an entity

ASC 606 (and ASC 610-20 by reference to ASC 606) provides guidance for contracts with customers involving the exchange of noncash consideration. As a result, the FASB excluded contracts that fall within the guidance of ASC 606 and ASC 610-20 from the scope of ASC 845 on nonmonetary transactions.

However, the FASB clarified in ASC 610-20-15-3(e) that the exchange of a nonfinancial asset (including an in substance nonfinancial asset) for a noncontrolling ownership interest in the receiving entity is within the scope of ASC 845. The guidance in ASC 845 states that if an exchange of a nonmonetary asset for a noncontrolling ownership interest in the receiving entity is accounted for at fair value, full or partial gain recognition is required if the fair value of the asset given up is greater than its carrying value. A loss is recognized if the carrying value of the asset given up exceeds its fair value.

UPDATE: In June 2016, the FASB proposed requiring exchanges of a nonfinancial asset for a noncontrolling ownership interest in the receiving entity to be accounted for under ASC 610-20, not ASC 845. Comments were due 5 August 2016. To finalize this change, the FASB will need to issue a final ASU.

11.2 Derecognition of the nonfinancial asset

ASC 610-20 provides the following guidance on when to derecognize a nonfinancial asset:

Excerpt from Accounting Standards Codification

Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets

Initial Recognition

610-20-25-1

An entity shall recognize a gain or loss in accordance with the derecognition guidance in Section 610 20-40.

Derecognition

610-20-40-1

To determine when a nonfinancial asset shall be derecognized, an entity shall apply the following paragraphs in Topic 606 on revenue from contracts with customers:

a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract

b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

610-20-40-2

When the guidance in paragraph 610-20-40-1 is met, an entity shall derecognize the nonfinancial asset and recognize as a gain or loss the difference between the amount of consideration measured in accordance with paragraph 610-20-32-1 and the carrying amount of the nonfinancial asset. When the guidance in paragraph 610-20-40-1 is not met, an entity shall apply the guidance in paragraphs 350-10-40-3 to intangible assets and 360-10-40-3C to property, plant, and equipment.

11.2.1 Existence of a contract

Before derecognizing a nonfinancial asset, an entity must first identify the contract, or contracts, to sell such assets. See Section 3.3 for guidance on when two or more contracts should be combined. These contracts may be written, oral or implied by the entity's customary business practices but must be legally enforceable and meet specified criteria, as outlined in ASC 606-10-25-1 (see Section 3.1 for a detailed discussion of those criteria). These criteria are assessed at the inception of the arrangement. If the criteria are met at that time, an entity does not reassess the criteria unless there is an indication of a significant change in facts and circumstances.

An entity must carefully evaluate whether a contract (particularly an oral or implied contract) is legally enforceable. In many cases in the US, a contract to sell or transfer nonfinancial assets must be written to be legally enforceable (e.g., many real estate transactions). Entities commonly execute these transactions using a signed, written contract that specifies the asset to be transferred and the amount to be paid. This generally will result in a straightforward assessment of most of the contract criteria. The assessment may be different when evaluating transactions that occur in countries outside of the US.

An entity also must conclude that it is probable that it will collect the transaction price, as discussed in Section 3.1.5. When evaluating whether collectibility of the transaction price is probable, an entity should consider the buyer's intent and ability to pay the amount of consideration when it is due. In some cases, an entity may conclude that it has offered or is willing to accept a price concession or other discount, as discussed in Section 5.2.1.1, that is a form of variable consideration and does not affect the collectibility assessment. In other cases, an entity may decide to transfer the asset even if it has doubts about the buyer's intent or ability to pay the transaction price for the asset. All facts and circumstances should be considered when making this determination.

How we see it

Entities will need to carefully evaluate whether each of their contracts should be accounted for under ASC 606 because not all legal contracts will meet the requirements of a contract under ASC 606-10-25-1.

Entities may find applying the collectibility criterion challenging. Significant judgment will be required to determine whether an expected partial payment from the counterparty indicates that (1) there is an implied price concession in the contract, (2) there is an impairment loss or (3) the arrangement lacks sufficient substance to be considered a contract within the scope of the guidance.

11.2.2 Accounting for consideration received when the contract criteria are not met

As noted in ASC 610-20-40-2, both ASC 350-10-40-3 and ASC 360-10-40-3C provide guidance for when an entity concludes that it is not probable that it will collect the transaction price or when any of the other criteria in ASC 606-10-25-1 are not met. This guidance requires an entity to continue to report the nonfinancial asset in its financial statements, recognize amortization or depreciation expense and evaluate the asset for impairment. Any consideration received from the buyer is initially accounted for as a liability that is measured at the amount of consideration received from the buyer. This approach is similar to the deposit method prescribed in ASC 360-20 (prior to amendments in ASU 2014-09) for sales of real estate.

The liability for any consideration received should continue to be recognized until the contract criteria in ASC 606-10-25-1 are met or until one of the events described in ASC 606-10-25-7 occurs. The events listed in ASC 606-10-25-7 are discussed in detail in Section 3.5.

11.2.3 Transferring control of the asset

If an entity determines that an arrangement meets the criteria to be accounted for as a contract as described in Section 11.2.1, it should derecognize the asset and recognize a gain or loss on the transaction when control of the underlying asset transfers to the buyer. As discussed in Section 7.2, ASC 606 defines control as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and also includes the ability to prevent others from directing the use of the asset and obtaining the benefits from it. The guidance in ASC 610-20 refers to indicators of the transfer of control in ASC 606-10-25-30 to determine when control of the underlying asset has transferred to the buyer. Those indicators include:

- The entity has a present right to payment for the asset.
- The buyer has legal title to the asset.
- The entity has transferred physical possession of the asset.
- The buyer has the significant risks and rewards of ownership of the asset.
- The buyer has accepted the asset.

ASC 606 provides guidance on how to apply these indicators, including how they relate to the definition of control and how the other implementation guidance in ASC 606 may affect the assessment of control (e.g., accounting for repurchase agreements), as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied at a Point in Time

606-10-25-30

If a **performance obligation** is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a **customer** obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset — If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

b. The customer has legal title to the asset — Legal title may indicate which party to a **contract** has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

c. The entity has transferred physical possession of the asset — The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

d. The customer has the significant risks and rewards of ownership of the asset — The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

e. The customer has accepted the asset — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

None of the indicators above are meant to be individually determinative. The Board also clarified[276] that the indicators are not meant to be a checklist and not all of them must be present to determine that the other party has gained control. Rather, the indicators are factors that are often present when a buyer has obtained control of an asset, and the list is meant to help entities apply the principle of control. An entity must consider all relevant facts and circumstances to determine whether control has transferred. For example, the fact that a buyer has physical possession of an asset but can't use it until a certain date may indicate that the selling entity still controls the asset, even though the buyer has physical possession. The indicators are discussed in further detail in Section 7.2.

How we see it

The guidance in ASC 610-20 differs significantly from legacy prescriptive requirements for gain or loss recognition on real estate sales. For example, under legacy GAAP, a sale or transfer of real estate and any profit on it is recognized only if the transaction is consummated, the buyer meets certain initial and continuing investment conditions, any receivable is not subject to future subordination and the seller doesn't have certain forms of continuing involvement in the real estate (i.e., a sale is based on the transfer of the risks and rewards of ownership).

In addition, the derecognition guidance will be new for entities that sell other types of nonfinancial assets (e.g., ships, planes, patents). The guidance also will be a change for entities that have applied ASC 810 to sales of subsidiaries (i.e., subsidiaries that are not in substance real estate) that are in substance nonfinancial assets.

[276] Paragraph BC155 of ASU 2014-09.

Under the new model, assuming that control of the asset has been transferred, a gain may be recognized if the transaction price of the sale (based on the guidance on measuring the gain or loss described below) exceeds the carrying amount of the real estate sold, even though the transaction may not have qualified as a sale under legacy real estate guidance.

11.3 Measuring the gain or loss

ASC 610-20 requires an entity to apply the measurement principles in ASC 606 to measure the consideration to be included in the calculation of the gain or loss recognized upon derecognition of a nonfinancial asset as follows:

Excerpt from Accounting Standards Codification

Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets

Measurement

610-20-32-1

To determine the amount of consideration to be included in the calculation of a gain or loss recognized upon the derecognition of a nonfinancial asset, an entity shall apply the following paragraphs in Topic 606 on revenue from contracts with customers:

a. Paragraphs 606-10-32-2 through 32-27 on determining the transaction price, including all of the following:

   1. Estimating variable consideration
   2. Constraining estimates of variable consideration
   3. The existence of a significant financing component
   4. Noncash consideration
   5. Consideration payable to a customer.

b. Paragraphs 606-10-32-42 through 32-45 on accounting for changes in the transaction price.

The consideration promised in a contract may include fixed and/or variable amounts. When determining the transaction price, entities must estimate the variable consideration expected to be received. The transaction price also will include the fair value of any noncash consideration (see Section 5.6), the effect of a significant financing component (i.e., the time value of money) (see Section 5.5) and the effect of any consideration payable to a customer[277] (see Section 5.7).

11.3.1 Variable consideration and the constraint

The transaction price may vary in amount and timing as a result of price concessions, incentives or bonuses. In addition, consideration may be contingent on the occurrence or nonoccurrence of a future event or earned as a percentage of an underlying measure (e.g., sales/revenues, EBITDA, operating performance).

[277] The term "consideration payable to a customer" is used in ASC 606. ASC 610-20 does not apply to contracts with customers but does refer to the consideration payable guidance in ASC 606. This chapter of our publication uses the term as it is used in ASC 606 to describe any consideration payable to a buyer in a transaction in the scope of ASC 610-20.

For contracts in which the promised consideration is variable, an entity will need to estimate the amount of consideration to which it expects to be entitled, as discussed in Section 5.2.2, using either an expected value method (sum of probability-weighted amounts) or a most likely amount method. An entity is required to use the method that best predicts the consideration to which it will be entitled, considering all information (historical, current and forecast) that is reasonably available.

The amount of variable consideration an entity can include in the transaction price is limited to the amount for which it is probable that a significant reversal will not occur when the uncertainties related to the variability are resolved, as discussed in Section 5.2.3. An entity should update both its estimate of the variable consideration and its evaluation of the likelihood of a significant reversal at each reporting date. Significant judgment will be required, and all facts and circumstances will need to be considered when determining whether it is probable that a significant reversal will not occur.

The following example from ASC 610-20 illustrates applying the constraint to variable consideration:

Excerpt from Accounting Standards Codification

Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets

Implementation Guidance and Illustrations

Example 1 — Sale of a Nonfinancial Asset for Variable Consideration

610-20-55-2

An entity sells the rights to in-process research and development that it recently acquired in a business combination and measured at fair value of $50 million in accordance with Topic 805 on business combinations. The buyer of the in-process research and development agrees to pay a nonrefundable amount of $5 million at inception plus 2 percent of sales of any products derived from the in-process research and development over the next 20 years. The entity concludes that the sale of in-process research and development is not a good or service that is an output of the entity's ordinary activities.

610-20-55-3

Topic 350 on goodwill and other intangibles requires the entity to apply the guidance on existence of a contract, control, and measurement in Topic 606 on revenue from contracts with customers to determine the amount and timing of income to be recognized as follows:

a. The entity concludes that the criteria for identifying a contract in paragraph 606-10-25-1 are met.

b. The entity also concludes that on the basis of the guidance in paragraph 606-10-25-30, it has transferred control of the in-process research and development asset to the buyer as of contract inception. This is because as of contract inception the buyer can use the in-process research and development's records, patents, and supporting documentation to develop potential products and the entity has relinquished all substantive rights to the in-process research and development asset.

c. In estimating the consideration received, the entity applies the guidance in Topic 606 on determining the transaction price, including estimating and constraining variable consideration. The entity estimates that the amount of consideration that it will receive from the sales-based royalty is $100 million over the 20-year royalty period. However, the entity cannot assert that it is probable that recognizing all of the estimated variable consideration in other income would not result in a significant reversal of that consideration. The entity reaches this conclusion on the basis of its assessment of factors in paragraph 606-10-32-12. In particular, the entity is aware that the variable consideration is highly susceptible to the actions and judgments of third parties, because it is based on the buyer completing the in-process research and development asset, obtaining regulatory approval for the output of the in-process research and development asset, and marketing and selling the output. For the same reasons, the entity also concludes that it could not include any amount, even a minimum amount, in the estimate of the consideration. Consequently, the entity concludes that the estimate of the consideration to be used in the calculation of the gain or loss upon the derecognition of the in-process research and development asset is limited to the $5 million fixed upfront payment.

610-20-55-4

At inception of the contract, the entity recognizes a net loss of $45 million ($5 million of consideration, less the in-process research and development asset of $50 million). The entity reassesses the transaction price at each reporting period to determine whether it is probable that a significant reversal would not occur from recognizing the estimate as other income and, if so, recognizes that amount as other income in accordance with paragraphs 606-10-32-14 and 606-10-32-42 through 32-45.

How we see it

Some entities may see significant changes in how they account for sales of nonfinancial assets in the scope of ASC 610-20 due to the measurement principles for variable consideration. For example, some entities may not have historically estimated consideration that was contingent on future events (i.e., variable consideration) because they recognized these amounts when they were received. Other entities may have recognized contingent consideration at its fair value or applied a loss recovery approach.

Entities may see another significant change if the transaction price includes variable consideration that is constrained at contract inception. In these instances, an entity may be required to recognize a loss upon derecognition of a nonfinancial asset even though the entity expects to ultimately recognize a gain on the sale when the uncertainty related to the transaction price is resolved.

11.4 Other aspects of ASC 606

ASC 610-20 refers to only certain aspects of ASC 606 and does not contain guidance for other situations that may affect sales of nonfinancial assets. For example, ASC 610-20 does not contain guidance on identifying performance obligations (i.e., units of accounting) or on allocating the transaction price to more than one nonfinancial asset that may be included in a contract, while ASC 606 provides specific guidance on both topics. In the absence of specific guidance in ASC 610-20 or other existing literature, we believe it would be reasonable for an entity to refer to the guidance in ASC 606.

UPDATE: In June 2016, the FASB proposed specifying that an entity should apply the guidance in ASC 606 on identifying performance obligations and allocating the transaction price to each performance obligation for nonfinancial assets in the scope of ASC 610-20. Comments were due 5 August 2016. To finalize this change, the FASB will need to issue a final ASU.

A Summary of important changes

We have made significant changes to this FRD since the August 2015 edition, primarily to address amendments the FASB has made to the standard and TRG implementation discussions, as well as to expand our discussions of certain topics. In addition, the FRD now includes FAQs and all ASC 606 and ASC 340-40 Codification guidance (but not all of the examples included in the Codification — see Appendix F). The previous version included only select Codification references. The list below summarizes the most significant new or revised content in this edition of our FRD.

Chapter 1 **Overview, effective date and transition**

- Updated Section 1.3 for transition amendments in ASU 2016-12
- Updated Section 1.3.4 for new Topic 11 of the SEC's Division of Corporation Finance's Financial Reporting Manual, *Reporting Issues Related to Adoption of New Revenue Recognition Standard*

Chapter 2 **Scope**

- Added seven FAQs in Section 2.4 on scoping

Chapter 3 **Identify the contract with the customer**

- Updated Section 3.1.5 for amendments to the collectibility guidance in ASU 2016-12
- Added Section 3.2 on contract enforceability and termination clauses
- Added flowchart in Section 3.4 on the contract modifications guidance
- Updated Section 3.5 for amendments to the guidance on recognition of nonrefundable consideration received for arrangements that to do meet the definition of a contract in ASU 2016-12

Chapter 4 **Identify the performance obligations in the contract**

- Updated Sections 4.1 and 4.2 for amendments on identifying performance obligations in ASU 2016-10
- Updated Section 4.4 for amendments on principal versus agent considerations in ASU 2016-08
- Added eight FAQs in Section 4.6 on customer options

Chapter 5 **Determine the transaction price**

- Added Section 5.1 on amendments on the presentation of sales (and other similar taxes) in ASU 2016-12
- Added eight FAQs in Section 5.2 on variable consideration
- Removed Illustration 5-1 from Section 5.2.3 (formerly Section 5.1.3) and replaced it with an example from TRG agenda paper no. 38 on estimating variable consideration using the expected value method
- Added Section 5.3 on refund liabilities
- Added seven FAQs in Section 5.5 on significant financing components
- Updated Section 5.6 for amendments on noncash consideration in ASU 2016-12 and added Illustration 5-1 on noncash consideration with variability due to both form and other reasons
- Expanded Section 5.7 on consideration paid or payable to a customer and added several subsections
- Added Section 5.9 on changes in the transaction price

Chapter 6 **Allocate the transaction price to the performance obligations**

- Added three FAQs in Section 6.1.4 on determining the standalone selling price
- Expanded Section 6.3 on the variable consideration allocation exception
- Revised Illustration 6-3 in Section 6.6 to illustrate an arrangement with elements in the scope of ASC 460 and ASC 606

Chapter 7 **Satisfaction of performance obligations**

- Expanded the discussion in Sections 7.1 and 7.2 on applying the notion of control to performance obligations satisfied over time and at a point in time
- Added nine FAQs in Section 7.1 on performance obligations satisfied over time

Chapter 8 **Licenses of intellectual property**

- New chapter on licenses of intellectual property (some of the content was formerly included in Section 8.4)
- Updated for ASU 2016-10

Chapter 9 **Other measurement and recognition topics**

- Added four FAQs in Section 9.1 on warranties
- Added four FAQs in Section 9.3.1 on costs to obtain a contract and added Illustration 9-3 on sales commissions
- Added four FAQs in Section 9.3.2 on costs to fulfill a contract
- Added two FAQs in Section 9.3.3 on amortization of capitalized costs
- Added new Section 9.3.4 on impairment of capitalized costs, including discussion of proposed technical corrections to this guidance

Chapter 10 **Presentation and disclosure**

- Added six FAQs in Section 10.1 on presentation considerations
- Added Section 10.6 on interim disclosure requirements
- Added Section 10.7 on transition disclosure requirements

Chapter 11 **Gains and losses from the derecognition of nonfinancial assets**

- Added chapter to discuss guidance in ASC 610-20 that requires entities to apply certain principles of the revenue standard (including estimating variable consideration) to sales of certain nonfinancial assets (e.g., real estate; intangible assets; property, plant and equipment)

B Index of ASC references used in this publication

ASC Reference	Section	
250-10-50-1 through 50-2	1.3.1	Full retrospective adoption
270-10-50-1A	10.6	Interim disclosure requirements
340-40-15-2	9.3.1	Costs to obtain a contract
340-40-15-3	9.3.2	Costs to fulfill a contract
340-40-25-1 through 25-4	9.3.1	Costs to obtain a contract
340-40-25-5 through 25-8	9.3.2	Costs to fulfill a contract
340-40-35-1 through 35-2	9.3.3	Amortization of capitalized costs
340-40-35-3 through 35-6	9.3.4	Impairment of capitalized costs
340-40-50-1 through 3	10.4.3	Disclosures for public entities — Assets recognized for the costs to obtain or fulfill a contract
340-40-50-4	10.5.3	Disclosures for nonpublic entities — Assets recognized for the costs to obtain or fulfill a contract
340-40-50-5	10.4.4	Disclosures for public entities — Practical expedients
340-40-50-6	10.5.4	Disclosures for nonpublic entities — Practical expedients
606-10-10-1 through 10-3	1.1.1	Core principle of the standard
606-10-10-4	3.3.1	Portfolio approach practical expedient
606-10-15-1 through 15-3	2	Scope
606-10-15-4	2.4	Interaction with other guidance
606-10-15-5	9.3	Contract costs
606-10-25-1	3.1	Attributes of a contract
606-10-25-2	3	Identify the contract with the customer
606-10-25-3 through 25-4	3.2	Contract enforceability and termination clauses
606-10-25-5	3.1	Attributes of a contract
606-10-25-6 through 25-8	3.5	Arrangements that do not meet the definition of a contract under the standard
606-10-25-9	3.3	Combining contracts
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606-10-25-14 through 25-15	4	Identifying the performance obligations in the contract
606-10-25-16 through 25-18	4.1	Identifying the promised goods and services in the contract
606-10-25-18A through 25-18B	4.1.2	Shipping and handling activities
606-10-25-19	4.2.1	Determination of distinct
606-10-25-20	4.2.1.1	Capable of being distinct
606-10-25-21	4.2.1.2	Distinct within the context of the contract
606-10-25-22	4.3	Promised goods and services that are not distinct
606-10-25-23 through 25-25	7	Satisfaction of performance obligations
606-10-25-25	4.4.2	Control of the specified good or service

ASC Reference	Section	
606-10-25-26	7.3	Repurchase agreements
606-10-25-27	7.1	Performance obligations satisfied over time
606-10-25-28 through 25-29	7.1.3	Asset with no alternative use and right to payment
606-10-25-30	7.2	Control transferred at a point in time
606-10-25-30	11.2.3	Transferring control of the asset
606-10-25-31 through 25-37	7.1.4	Measuring progress
606-10-32-1 through 32-4	5	Determine the transaction price
606-10-32-5 through 32-7	5.2	Variable consideration
606-10-32-8 through 32-9	5.2.2	Estimating variable consideration
606-10-32-10	5.3	Refund liabilities
606-10-32-11 through 32-13	5.2.3	Constraining estimates of variable consideration
606-10-32-14	5.2.4	Reassessment of variable consideration
606-10-32-15 through 32-19	5.5	Significant financing component
606-10-32-20	5.5.2	Financial statement presentation of financing component
606-10-32-21 through 32-24	5.6	Noncash consideration
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606-10-32-31 through 32-35	6.1	Determining standalone selling prices
606-10-32-36 through 32-38	6.4	Allocating a discount
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606-10-32-42 through 32-45	6.5	Changes in transaction price after contract inception
606-10-45-1 through 45-5	10.1	Presentation requirements for contract assets and contract liabilities
606-10-50-1 through 50-2	10.3	Annual disclosure requirements
606-10-50-3	10.4	Disclosures for public entities
606-10-50-4 through 50-6	10.4.1	Disclosures for public entities — Contracts with customers
606-10-50-8 through 50-10	10.4.1	Disclosures for public entities — Contracts with customers
606-10-50-12 through 50-15	10.4.1	Disclosures for public entities — Contracts with customers
606-10-50-17 through 20	10.4.2	Disclosures for public entities — Significant judgments
606-10-50-22	10.4.4	Disclosures for public entities — Practical expedients
606-10-50-8 through 10-16	10.5.1	Disclosures for nonpublic entities — Contracts with customers
606-10-50-17 through 21	10.5.2	Disclosures for nonpublic entities — Significant judgments
606-10-50-23	10.5.4	Disclosures for nonpublic entities — Practical expedients
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606-10-55-5 through 55-6	7.1.1	Customer simultaneously receives and consumes benefits as the entity performs
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606-10-55-31 through 55-33	9.1.1	Determining whether a warranty is an assurance- or service-type warranty
606-10-55-34	9.1.4	Contracts that contain both assurance- and service-type warranties
606-10-55-35	9.1.1	Determining whether a warranty is an assurance- or service-type warranty
606-10-55-36 through 55-37	4.4	Principal versus agent considerations
606-10-55-37A	4.4.2	Control of the specified good or service
606-10-55-37B through 55-38	4.4.3	Recognizing revenue as a principal or agent
606-10-55-39 through 55-39A	4.4.2.1	Principal indicators
606-10-55-40	4.4.3	Recognizing revenue as a principal or agent
606-10-55-41 through 55-43	4.6	Customer options for additional goods or services
606-10-55-44 through 55-45	6.1.5	Measurement of options that are separate performance obligations
606-10-55-46 through 55-49	7.9	Breakage and prepayments for future goods or services
606-10-55-50 through 55-53	5.8	Nonrefundable up-front fees
606-10-55-54	8	Licenses of intellectual property
606-10-55-55	8.1	Identifying performance obligations in a licensing arrangement
606-10-55-56	8.1.2	Licenses of intellectual property that are not distinct
606-10-55-57	8.2.4	Applying the licenses guidance to a bundled performance obligation that includes a license of intellectual property
606-10-55-58 through 55-58C	8.3	Transfer of control of licensed intellectual property
606-10-55-59	8.2	Determining the nature of the entity's promise in granting a license
606-10-55-60	8.2.2	Symbolic intellectual property
606-10-55-62 through 55-63	8.2.1	Functional intellectual property
606-10-55-63A	8.2.3	Evaluating functional versus symbolic intellectual property
606-10-55-64	8.1.3	Contractual restrictions
606-10-55-64A	8.1.4	Guarantees to defend or maintain a patent
606-10-55-65 through 55-65B	8.5	Sales- or usage-based royalties on licenses of intellectual property
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606-10-55-68 through 55-71	7.3.1	Forward or call option held by the entity
606-10-55-72 through 55-78	7.3.2	Put option held by the customer
606-10-55-79 through 55-80	7.4	Consignment arrangements
606-10-55-81 through 55-84	7.5	Bill-and-hold arrangements
606-10-55-85 through 55-88	7.2.1	Customer acceptance
606-10-55-89 through 55-91	10.4.1	Disclosures for public entities — Contracts with customers
606-10-65-1	1.2	Effective date
606-10-65-1	1.3	Transition method
610-20-05-1	11.1	Scope of ASC 610-20
610-20-15-1 through 15-3	11.1	Scope of ASC 610-20
610-20-25-1	11.2	Derecognition of the nonfinancial asset
610-20-32-1	11.3	Measuring the gain or loss
610-20-40-1 through 40-2	11.2	Derecognition of the nonfinancial asset

C Guidance abbreviations used in this publication

Abbreviation	Full title of guidance reference
ASC 210-20	FASB ASC Topic 210-20, *Balance Sheet — Offsetting*
ASC 235	FASB ASC Topic 235, *Notes to Financial Statements*
ASC 250	FASB ASC Topic 250, *Accounting Changes and Error Corrections*
ASC 270	FASB ASC Topic 270, *Interim Reporting*
ASC 280	FASB ASC Topic 280, *Segment Reporting*
ASC 310	FASB ASC Topic 310, *Receivables*
ASC 320	FASB ASC Topic 320, *Investments — Debt and Equity Securities*
ASC 330	FASB ASC Topic 330, *Inventory*
ASC 340	FASB ASC Topic 340, *Other Assets and Deferred Costs*
ASC 340-40	FASB ASC Topic 340, *Other Assets and Deferred Costs — Contracts with Customers*
ASC 350	FASB ASC Topic 350, *Intangibles — Goodwill and Other*
ASC 360	FASB ASC Topic 360, *Property, Plant, and Equipment*
ASC 360-20	FASB ASC Topic 360-20, *Property, Plant, and Equipment — Real Estate Sales*
ASC 405	FASB ASC Topic 405, *Liabilities*
ASC 420	FASB ASC Topic 420, E*xit or Disposal Cost Obligations*
ASC 440	FASB ASC Topic 440, *Commitments*
ASC 460	FASB ASC Topic 460, *Guarantees*
ASC 470-40	FASB ASC Topic 470-40, *Product Financing Arrangements*
ASC 605	FASB ASC Topic 605, *Revenue Recognition*
ASC 605-20	FASB ASC Topic 605-20, *Revenue Recognition — Services*
ASC 605-25	FASB ASC Topic 605-25, *Revenue Recognition — Multiple-Element Arrangements*
ASC 605-35	FASB ASC Topic 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*
ASC 605-45	FASB ASC Topic 605-45, *Revenue Recognition — Principal Agent Considerations*
ASC 605-50	FASB ASC Topic 605-50, *Customer Payments and Incentives*
ASC 606	FASB ASC Topic 606, *Revenue from Contracts with Customers*
ASC 610-20	FASB ASC Topic 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*
ASC 710	FASB ASC Topic 710, *Compensation*
ASC 720-15	FASB ASC Topic 720-15, *Other Expenses — Start-up Costs*
ASC 730	FASB ASC Topic 730, *Research and Development*
ASC 808	FASB ASC Topic 808, *Collaborative Arrangements*
ASC 810	FASB ASC Topic 810, *Consolidation*
ASC 815	FASB ASC Topic 815, *Derivatives and Hedging*
ASC 820	FASB ASC Topic 820, *Fair Value Measurement*
ASC 830-20	FASB ASC Topic 830-20, *Foreign Currency Transactions*
ASC 835	FASB ASC Topic 835, *Interest*
ASC 840	FASB ASC Topic 840, *Leases*

Abbreviation	Full title of guidance reference
ASC 840-40	FASB ASC Topic 840, *Leases — Sale-Leaseback Transactions*
ASC 842	FASB ASC Topic 842, *Leases*
ASC 845	FASB ASC Topic 845, *Nonmonetary Transactions*
ASC 860	FASB ASC Topic 860, *Transfers and Servicing*
ASC 924-605	FASB ASC Topic 924, FASB ASC Topic 924-605, *Entertainment — Casinos — Revenue Recognition*
ASC 944	FASB ASC Topic 944, *Financial Services — Insurance*
ASC 954-450	FASB ASC Topic 954-450, *Healthcare Entities — Contingencies*
ASC 958-605	FASB ASC Topic 958-605, *Not-for-Profit Entities — Revenue Recognition*
ASC 985-20	FASB ASC Topic 958-605, *Costs of Software to Be Sold, Leased, or Marketed*
ASC 985-605	FASB ASC Topic 985-605, *Software — Revenue Recognition*
ASU 2013-12	Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity*
ASU 2014-09	Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*
ASU 2015-14	Accounting Standards Update No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*
ASU 2016-02	Accounting Standards Update No. 2016-02, *Leases (Topic 842)*
ASU 2016-08	Accounting Standards Update No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*
ASU 2016-10	Accounting Standards Update No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*
ASU 2016-12	Accounting Standards Update No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*
CON 6	FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*
EITF D-96	Emerging Issues Task Force Issue No. D-96, *Accounting for Management Fees Based on a Formula*
IAS 11	International Accounting Standard 11 *Construction Contracts*
IAS 18	International Accounting Standard 18 *Revenue*
IAS 21	International Accounting Standard 21 *The Effects of Changes in Foreign Exchange Rates*
IAS 34	International Accounting 34 *Interim Financial Reporting*
IAS 37	International Accounting 37 *Provisions, Contingent Liabilities and Contingent Assets*
IAS 39	International Accounting Standard 39 *Financial Instruments: Recognition and Measurement*
IFRS 2	International Financial Reporting Standard 2 *Share-based Payment*
IFRS 9	International Financial Reporting Standard 9 *Financial Instruments*
IFRS 15	International Financial Reporting Standard 15 *Revenue from Contracts with Customers*
SAB Topic 1.M	Codified SEC Staff Accounting Bulletin, Topic 1.M, *Materiality*
SAB Topic 11.M	Codified SEC Staff Accounting Bulletin, Topic 11.M, *Disclosure of the Impact that Recently Issued Accounting Standards Will have on the Financial Statements of the Registrant when Adopted in a Future Period*
SAB Topic 13	Codified SEC Staff Accounting Bulletin, Topic 13, *Revenue Recognition*
SOP 97-2	Statement of Position 97-2, *Software Revenue Recognition*

D Disclosure checklist — Public entities

	Yes	No	N/A	Reference/explanation
Note: In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)* that will supersede virtually all recognition guidance in US GAAP. For public entities, the guidance is effective for annual and interim periods beginning after 15 December 2017. For nonpublic entities, it is effective for annual periods beginning after 15 December 2018, and interim periods beginning after 15 December 2019. Early adoption is permitted for all entities for annual and interim periods beginning after 15 December 2016. The FASB issued the following ASUs to amend the new guidance: ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date* ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)* ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing* ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients* The standard defines a public entity as one of the following: ▸ A public business entity ▸ A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market ▸ An employee benefit plan that files or furnishes financial statements with the U.S. Securities and Exchange Commission (SEC) ASU 2013-12, *Definition of a Public Business Entity*, states that a business entity is a public business entity if it meets any of the following criteria: ▸ "(a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). ▸ (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. ▸ (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. ▸ (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. ▸ (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion."				

	Yes	No	N/A	Reference/explanation
An entity that does not meet any of the above is considered a nonpublic entity for purposes of this standard.				
Contracts with customers				
1. An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other disclosure requirements: (606-10-50-4)				
a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue				
b. Any impairment losses recognized (in accordance with ASC 310 on receivables) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses on other contracts				
Disaggregation of revenue				
2. An entity shall disclose the following related to disaggregated revenue:				
a. An entity shall disclose disaggregated revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue. (606-10-50-5) Note: Paragraph 606-10-50-5 requires an entity to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 606-10-50-5 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue. (606-10-55-89)				
b. When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following: (606-10-55-90)				
i. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports or investor presentations)				
ii. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments				
iii. Other information that is similar to the types of information identified in (i) and (ii) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions				
Note: Examples of categories that might be appropriate include, but are not limited to, all of the following: (606-10-55-91) (a) Type of good or service (for example, major product lines) (b) Geographical region (for example, country or region) (c) Market or type of customer (for example, government and nongovernment customers)				

	Yes	No	N/A	Reference/explanation
(d) Type of contract (for example, fixed-price and time-and-materials contracts) (e) Contract duration (for example, short-term and long-term contracts) (f) Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time) (g) Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries)				
c. An entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies ASC 280 on segment reporting. (606-10-50-6)				
Contract balances				
3. An entity shall disclose all of the following: (606-10-50-8)				
a. The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed				
b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period				
c. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous reporting periods (for example, changes in transaction price)				
4. An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and contract liability balances. The explanation provided may use qualitative information. (606-10-50-9)				
5. An entity shall provide an explanation of the significant changes in the contract asset and contract liability balances during the reporting period. The explanation should include qualitative and quantitative information. Examples of significant changes include any of the following: (606-10-50-10)				
a. Changes due to business combinations				
b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, the estimate of the transaction price (including any constrained amounts) or a contract modification				
c. Impairment of a contract asset				
d. A change in the timeframe for a right to consideration to become unconditional (i.e., a contract asset reclassified to a receivable)				
e. A change in the timeframe for a performance obligation to be satisfied (i.e., the recognition of revenue arising from a contract liability)				

	Yes	No	N/A	Reference/explanation
Performance obligations				
6. An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following: (606-10-15-12)				
a. When the entity typically satisfies its performance obligations (e.g., upon shipment, upon delivery, as a bill and hold arrangement, as services are rendered, upon completion of service)				
b. The significant payment terms (e.g., when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, whether such estimate is constrained in accordance with paragraphs 606-10-32-11 through 32-13)				
c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e., if the entity is acting as an agent)				
d. Obligations for returns, refunds and other similar obligations				
e. Types of warranties and related obligations				
7. An entity shall disclose the aggregate amount of the transaction price allocated to remaining performance obligations as of the end of the current reporting period. (606-10-50-13(a))				
8. An entity shall explain when the entity expects to recognize the amount disclosed in accordance with paragraph 606-10-50-13(a) either on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or by using qualitative information. (606-10-50-13(b))				
9. As a practical expedient, an entity need not disclose the information in paragraphs 606-10-50-13(a) and 50-13(b) for a performance obligation if either of the following conditions are met: (606-10-50-14)				
a. The performance obligation is part of a contract that has an original expected duration of less than one year				
b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18				
10. An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 606-10-50-14 and whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13). (606-10-50-15)				
Significant judgments in the application of the guidance in ASC 606				
11. An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in ASC 606 that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following: (606-10-50-17)				

	Yes	No	N/A	Reference/explanation
a. The timing of satisfaction of performance obligations (see paragraphs 606-10-50-18 through 50-19)				
b. The transaction price and the amounts allocated to performance obligations (see paragraph 606-10-50-20)				
12. For performance obligations that an entity satisfies over time, an entity shall disclose both of the following: (606-10-50-18)				
a. The methods used to recognize revenue (e.g., a description of the output methods or input methods used and how these methods are applied)				
b. An explanation of why the methods used are a faithful depiction of the transfer of goods or services				
13. For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when the customer obtains control of promised goods or services. (606-10-50-19)				
14. An entity shall disclose information about the methods, inputs and assumptions used for all of the following: (606-10-50-20)				
a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring noncash consideration				
b. Assessing whether an estimate of variable consideration is constrained				
c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)				
d. Measuring obligations for returns, refunds and other similar obligations				
Costs to obtain or fulfill a contract				
15. An entity shall describe both of the following: (340-40-50-2)				
a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5)				
b. The method it uses to determine the amortization for each reporting period				
16. An entity shall disclose all of the following: (340-40-50-3)				
a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph340-40-25-1 or 340-40-25-5) by main category of asset (for example, costs to obtain contracts with customers, pre-contract costs, setup costs)				
b. The amount of amortization and any impairment losses recognized in the reporting period				
Practical expedients				
17. If an entity uses either the practical expedient in paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a contract), the entity shall disclose that fact. (606-10-50-22 and 340-40-50-5)				

	Yes	No	N/A	Reference/explanation
Accounting policies				
18. An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (e.g., sales, use, value added, some excise taxes). An entity that makes this election shall comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6. (606-10-32-2A)				
19. If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. An entity that makes this election shall comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6. (606-10-25-18B)				
Effective date and transition disclosures				
20. An entity that applies the standard retrospectively to each prior reporting period (i.e., using the full retrospective approach) is required to make the disclosures required by paragraphs 250-10-50-1 through 50-2 in the fiscal period in which the standard is adopted: (**Note:** An entity need not disclose the effect of the changes on the current period, which otherwise would be required by paragraph 250-10-50-1(b)(2)). (606-10-65-1(e))				
a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable				
b. The method of applying the change, and:				
i. A description of the prior-period information that has been retrospectively adjusted, if any				
ii. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required. (**Note:** An entity need not disclose the effect of the changes on the current period, which otherwise would be required by this paragraph in ASC 250).				
iii. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented				
iv. If retrospective application to all prior periods is impracticable, disclose the reasons and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).				
c. If indirect effects of a change in accounting principle are recognized:				
i. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable				

	Yes	No	N/A	Reference/explanation
ii. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented				
d. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures specified in item 20.a. above shall be provided whenever the financial statements of the period of change are presented. (250-10-50-1)				
e. The SEC staff has stated that while labeling financial statement columns "as adjusted" for a change in accounting principle is not explicitly required, it is considered a best practice to facilitate as much transparency as possible. (SP — AICPA/SEC Regulations Committee, Current Practice Issues, dated 9/26/06, Discussion Document D)				
f. The transition practical expedients that have been used: (606-10-65-1(g)(1))				
i. Disclose that the entity has not restated completed contracts that begin and end in the same annual reporting period. (606-10-65-1(f)(1))				
ii. Disclose the entity's use of the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. (606-10-65-1(f)(2))				
iii. Disclose that the entity has not disclosed the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue for the reporting periods presented prior to the initial date of application. (606-10-65-1(f)(3))				
iv. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the standard, disclose that the entity has not retrospectively restated the contract for those modifications in accordance with the contract modification guidance in paragraphs 606-10-25-12 and 25-13. Disclose that the entity instead reflected the aggregate effect of all modifications when identifying the satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price. (606-10-65-1(f)(4))				
g. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of the expedients listed in item 20.f. (606-10-65-1(g)(2))				
21. An entity that applies the standard retrospectively with the cumulative effect recognized at the date of initial application (i.e., using a modified retrospective approach) is required to disclose the following in the fiscal period in which the standard is adopted: (606-10-65-1(h))				
a. Whether the entity has applied the standard to all contracts or only to contracts that are not completed at the date of initial application.				
b. The transition practical expedients that have been used: (606-10-65-1(g)(1))				
i. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the standard disclose that the entity has not retrospectively restated the contract for those modifications in accordance with the contract modification guidance in paragraphs 606-10-25-12 and 25-13. Disclose that the entity instead reflected the aggregate effect of all modifications when identifying the satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price. (606-10-65-1(h), 606-10-65-1(f)(4))				

	Yes	No	N/A	Reference/explanation
c. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying the expedients listed in item 21.b. (606-10-65-1(h), 606-10-65-1(g)(2))				
d. The amount by which each financial statement line item is affected in the current reporting period by the standard as compared with the guidance that was in effect before the change (606-10-65-1(i)(1))				
e. An explanation of the reasons for significant changes identified in item 21.d. (606-10-65-1(i)(2))				

E Disclosure checklist — Nonpublic entities

	Yes	No	N/A	Reference/explanation
Note: In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)* that will supersede virtually all recognition guidance in US GAAP. For nonpublic entities, it is effective for annual periods beginning after 15 December 2018, and interim periods beginning after 15 December 2019. Early adoption is permitted for all entities for annual and interim periods beginning after 15 December 2016. The FASB issued the following ASUs to amend the new guidance: ASU 2015-14, *Revenue from Contracts with Customers (Topic 606), Deferral of the Effective Date* ASU 2016-08, *Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue Gross versus Net)* ASU 2016-10, *Revenue from Contracts with Customers (Topic 606), Identifying Performance Obligations and Licensing* ASU 2016-12, *Revenue from Contracts with Customers (Topic 606), Narrow-Scope Improvements and Practical Expedients* The standard defines a public entity as one of the following: ‣ A public business entity ‣ A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market ‣ An employee benefit plan that files or furnishes financial statements with the U.S. Securities and Exchange Commission (SEC) ASU 2013-12, *Definition of a Public Business Entity,* states that a business entity is a public business entity if it meets any of the following criteria: ‣ "(a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). ‣ (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. ‣ (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. ‣ (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. ‣ (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion."				

	Yes	No	N/A	Reference/explanation
An entity that does not meet any of the above is considered a nonpublic entity for purposes of this standard.				
Contracts with customers				
1. An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other disclosure requirements: (606-10-50-4)				
a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue				
b. Any impairment losses recognized (in accordance with ASC 310 on receivables) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses on other contracts				
Disaggregation of revenue				
2. An entity shall disclose, at a minimum, the following related to disaggregated revenue: (660-10-50-7)				
a. Revenue disaggregated according to the timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time)				
b. Qualitative information about how economic factors (e.g., type of customer, geographical information of customers, types of contract) affect the nature, amount, timing and uncertainty of revenue and cash flows				
Contract balances				
3. An entity shall disclose, at a minimum, the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed. (606-10-50-11)				
Performance obligations				
4. An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following: (606-10-50-12)				
a. When the entity typically satisfies its performance obligations (e.g., upon shipment, upon delivery, as a bill and hold arrangement, as services are rendered, upon completion of service)				
b. The significant payment terms (e.g., when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, whether such estimate is constrained in accordance with paragraph 606-10-32-11 through 32-13)				
c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e., if the entity is acting as an agent)				
d. Obligations for returns, refunds and other similar obligations				
e. Types of warranties and related obligations				

	Yes	No	N/A	Reference/explanation
Significant judgments in the application of the guidance in ASC 606				
5. An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in ASC 606 that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, a nonpublic entity shall, at a minimum, disclose the following: (606-10-50-17)				
a. For performance obligations that an entity satisfies over time, the methods used to recognize revenue (e.g., a description of the output methods or input methods used and how these methods are applied) (606-10-50-18a)				
b. Information about the methods, inputs and assumptions used for assessing whether an estimate of variable consideration is constrained (606-10-50-20(b))				
Accounting policies				
6. An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added and some excise taxes). An entity that makes this election shall comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6. (606-10-32-2A)				
7. If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. An entity that makes this election shall comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6. (606-10-25-18B)				
Effective date and transition disclosures				
8. An entity that applies the standard retrospectively to each prior reporting period (i.e., using the full retrospective approach), is required to make the disclosures required by paragraphs 250-10-50-1 through 50-2 in the fiscal period in which the standard is adopted: (**Note:** An entity need not disclose the effect of the changes on the current period, which otherwise would be required by paragraph 250-10-50-1(b)(2)). (606 10-65-1(e))				
a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable				
b. The method of applying the change, and:				
i. A description of the prior-period information that has been retrospectively adjusted, if any				
ii. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required. (**Note:** An entity need not disclose the effect of the changes on the current period, which otherwise would be required by this paragraph.)				

	Yes	No	N/A	Reference/explanation
iii. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented				
iv. If retrospective application to all prior periods is impracticable, disclose the reasons and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).				
c. If indirect effects of a change in accounting principle are recognized:				
i. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable				
ii. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented				
d. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures specified in item 8.a. above shall be provided whenever the financial statements of the period of change are presented. (250-10-50-1)				
e. The SEC staff has stated that while labeling financial statement columns "as adjusted" for a change in accounting principle is not explicitly required, it is considered a best practice to facilitate as much transparency as possible. (SP — AICPA/SEC Regulations Committee, Current Practice Issues, dated 9/26/06, Discussion Document D)				
f. The transition practical expedients that have been used: (606-10-65-1(g)(1))				
i. Disclose that the entity has not restated completed contracts that begin and end in the same annual reporting period. (606-10-65-1(f)(1))				
ii. Disclose the entity's use of the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. (606-10-65-1(f)(2))				
iii. Disclose that the entity has not disclosed the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue for the reporting periods presented prior to the initial date of application. (606-10-65-1(f)(3))				
iv. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the standard, disclose that the entity has not retrospectively restated the contract for those modifications in accordance with the contract modification guidance in paragraphs 606-10-25-12 and 25-13. Disclose that the entity instead reflected the aggregate effect of all modifications when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price. (606-10-65-1(f)(4))				
g. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of the transition practical expedients listed in item 8.f. (606-10-65-1(g)(2))				

	Yes	No	N/A	Reference/explanation
9. An entity that applies the standard retrospectively with the cumulative effect recognized at the date of initial application (i.e., using a modified retrospective approach), is required to disclose the following in the fiscal period in which the standard is adopted: (606-10-65-1(h))				
a. Whether the entity has applied the standard to all contracts or only to contracts that are not completed at the date of initial application.				
b. The transition practical expedients that have been used:				
i. For contracts that were modified before the beginning of the earliest reporting period presented in accordance with the standard disclose that the entity has not retrospectively restated the contract for those modifications in accordance with the contract modification guidance in paragraphs 606-10-25-12 and 25-13. Disclose that the entity instead reflected the aggregate effect of all modifications when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price (606-10-65-1(h), 606-10-65-1(f)(4))				
c. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying the expedients listed in item 9.b. (606-10-65-1(h), 606-10-65-1(g)(2))				
d. The amount by which each financial statement line item is affected in the current reporting period by the standard as compared with the guidance that was in effect before the change (606-10-65-1(i)(1))				
e. An explanation of the reasons for significant changes identified in item 9.d. (606-10-65-1(i)(2))				

F List of examples included in ASC 606 and references in this publication

Identifying the Contract		
Example 1	Collectibility of the Consideration	
	Case A — Collectibility Is Not Probable	Not included
	Case B — Credit Risk Is Mitigated	Section 3.1.5
	Case C — Credit Risk Is Not Mitigated	Section 3.1.5
	Case D — Advance Payment	Not included
Example 2	Consideration Is Not the Stated Price — Implicit Price Concession	Section 5.2.1.1
Example 3	Implicit Price Concession	Not included
Example 4	Reassessing the Criteria for Identifying a Contract	Not included
Contract Modifications		
Example 5	Modification of a Contract for Goods	
	Case A — Additional Products for a Price That Reflects the Standalone Selling Price	Section 3.4.1
	Case B — Additional Products for a Price That Does Not Reflect the Standalone Selling Price	Section 3.4.2
Example 6	Change in the Transaction Price after a Contract Modification	Not included
Example 7	Modification of a Services Contract	Not included
Example 8	Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue	Section 3.4.2
Example 9	Unapproved Change in Scope and Price	Section 3.4
Identifying Performance Obligations		
Example 10	Goods and Services Are Not Distinct	
	Case A — Significant Integration Service	Section 4.2.3
	Case B — Significant Integration Service	Section 4.2.3
	Case C — Combined Item	Section 4.2.3
Example 11	Determining Whether Goods or Services Are Distinct	
	Case A — Distinct Goods or Services	Section 4.2.3
	Case B — Significant Customization	Section 4.2.3
	Case C — Promises Are Separately Identifiable (Installation)	Section 4.2.3
	Case D — Promises Are Separately Identifiable (Contractual Restrictions)	Section 4.2.3
	Case E — Promises Are Separately Identifiable (Consumables)	Section 4.2.3
Example 12	Explicit and Implicit Promises in a Contract	
	Case A — Explicit Promise of Service	Section 4.1
	Case B — Implicit Promise of Service	Section 4.1
	Case C — Services are Not a Promised Service	Section 4.1
Example 12A	Series of Distinct Goods or Services	Section 4.2.3
Performance Obligations Satisfied Over Time		
Example 13	Customer Simultaneously Receives and Consumes the Benefits	Section 7.1.1
Example 14	Assessing Alternative Use and Right to Payment	Section 7.1.3

Example 15	Asset Has No Alternative Use to the Entity	Section 7.1.3
Example 16	Enforceable Right to Payment for Performance Completed to Date	Section 7.1.3
Example 17	Assessing Whether a Performance Obligation Is Satisfied at a Point in Time or Over Time	
	Case A — Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date	Section 7.1.3
	Case B — Entity Has an Enforceable Right to Payment for Performance Completed to Date	Section 7.1.3
	Case C — Entity Has an Enforceable Right to Payment for Performance Completed to Date	Section 7.1.3
Measuring Progress toward Complete Satisfaction of a Performance Obligation		
Example 18	Measuring Progress When Making Goods or Services Available	Section 7.1.4.3
Example 19	Uninstalled Materials	Section 7.1.4.2
Variable Consideration		
Example 20	Penalty Gives Rise to Variable Consideration	Not included
Example 21	Estimating Variable Consideration	Not included
Constraining Estimates of Variable Consideration		
Example 22	Right of Return	Section 5.4.1
Example 23	Price Concessions	
	Case A — Estimate of Variable Consideration Is Not Constrained	Section 5.2.3
	Case B — Estimate of Variable Consideration Is Constrained	Section 5.2.3
Example 24	Volume Discount Incentive	Section 5.2.1
Example 25	Management Fees Subject to the Constraint	Section 5.2.3
The Existence of a Significant Financing Component in the Contract		
Example 26	Significant Financing Component and Right of Return	Section 5.5.1
Example 27	Withheld Payments on a Long-Term Contract	Section 5.5.1
Example 28	Determining the Discount Rate	
	Case A — Contractual Discount Rate Reflects the Rate in a Separate Financing Transaction	Section 5.5.1
	Case B — Contractual Discount Rate Does Not Reflect the Rate in a Separate Financing Transaction	Section 5.5.1
Example 29	Advance Payment and Assessment of Discount Rate	Section 5.5.1
Example 30	Advance Payment	Section 5.5.1
Noncash Consideration		
Example 31	Entitlement to Noncash Consideration	Section 5.6
Consideration Payable to a Customer		
Example 32	Consideration Payable to a Customer	Section 5.7.3
Allocating the Transaction Price to Performance Obligations		
Example 33	Allocation Methodology	Section 6.1.2
Example 34	Allocating a Discount	
	Case A — Allocating a Discount to One or More Performance Obligations	Section 6.4
	Case B — Residual Approach Is Appropriate	Section 6.4
	Case C — Residual Approach Is Inappropriate	Section 6.4
Example 35	Allocation of Variable Consideration	
	Case A — Variable Consideration Allocated Entirely to One Performance Obligation	Sections 6.3 & 8.5
	Case B — Variable Consideration Allocated On the Basis of Standalone Selling Prices	Sections 6.3 & 8.5
Contract Costs		
Example 36	Incremental Costs of Obtaining a Contract (refers to ASC 340-40 Example 1)	Section 9.3.1
Example 37	Costs That Give Rise to an Asset (refers to ASC 340-40 Example 2)	Section 9.3.2

Presentation		
Example 38	Contract Liability and Receivable	
	Case A — Cancellable Contract	Section 10.1
	Case B — Noncancellable Contract	Section 10.1
Example 39	Contract Asset Recognized for the Entity's Performance	Section 10.1
Example 40	Receivable Recognized for the Entity's Performance	Not included
Disclosure		
Example 41	Disaggregation of Revenue — Quantitative Disclosure	Section 10.4.1
Example 42	Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations	Section 10.4.1
Example 43	Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations — Qualitative Disclosure	Section 10.4.1
Warranties		
Example 44	Warranties	Not included
Principal versus Agent Considerations		
Example 45	Arranging for the Provision of Goods or Services (Entity is an Agent)	Not included
Example 46	Promise to Provide Goods or Services (Entity is a Principal)	Not included
Example 46A	Promise to Provide Goods or Services (Entity Is a Principal)	Section 4.4.4
Example 47	Promise to Provide Goods or Services (Entity is a Principal)	Section 4.4.4
Example 48	Arranging for the Provision of Goods or Services (Entity is an Agent)	Section 4.4.4
Example 48A	Entity Is a Principal and an Agent in the Same Contract	Section 4.4.4
Customer Options for Additional Goods or Services		
Example 49	Option That Provides the Customer with a Material Right (Discount Voucher)	Section 4.6
Example 50	Option That Does Not Provide the Customer with a Material Right (Additional Goods or Services)	Not included
Example 51	Option that Provides the Customer with a Material Right (Renewal Option)	Not included
Example 52	Customer Loyalty Program	Section 7.9
Nonrefundable Upfront Fees		
Example 53	Nonrefundable Upfront Fee	Not included
Licensing		
Example 54	Right to Use Intellectual Property	Section 8.2.1
Example 55	License of Intellectual Property	Not included
Example 56	Identifying a Distinct License	
	Case A — License is Not Distinct	Section 8.2.4
	Case B — License is Distinct	Section 8.1.1
Example 57	Franchise Rights	Not included
Example 58	Access to Intellectual Property	Section 8.2.2
Example 59	Right to Use Intellectual Property	
	Case A — Initial License	Section 8.4
	Case B — Renewal of the License	Section 8.4
Example 60	Sales-based Royalty Promised in Exchange for a License of Intellectual Property and Other Goods and Services	Section 8.5
Example 61	Access to Intellectual Property	Section 8.5
Example 61A	Right to Use Intellectual Property	
	Case A — License Is the Only Promise in the Contract	Not included
	Case B — Contract Includes Two Promises	Not included
Example 61B	Distinguishing Multiple Licenses from Attributes of a Single License	Section 8.1.3

Repurchase Arrangements		
Example 62	Repurchase Agreements	
	Case A — Call Option: Financing	Section 7.3.1
	Case B — Put Option: Lease	Section 7.3.2
Bill-and-Hold Arrangements		
Example 63	Bill-and-Hold Arrangement	Section 7.5

G TRG discussions and references in this publication

Date of TRG Meeting	Agenda Paper No.	Topic Discussed	FRD Section
18 July 2014	1	Gross versus Net Revenue	TRG discussions led to amended FASB guidance discussed in Section 4.4
	2	Gross versus Net Revenue: Amounts Billed to Customers	Section 4.4.4
	3	Sales-Based and Usage-Based Royalties in Contracts with Licenses and Goods or Services Other than Licenses	TRG discussions led to amended FASB guidance discussed in Section 8.5
	4	Impairment Testing of Capitalized Contract Costs	TRG discussions led to proposed FASB technical correction discussed in Section 9.3.4
31 October 2014	5	July 2014 Meeting — Summary of Issues Discussed and Next Steps	Not applicable
	6	Customer Options for Additional Goods and Services and Nonrefundable Upfront Fees	Section 4.6
	7	Presentation of a Contract as a Contract Asset or a Contract Liability	Section 10.1
	8	Determining the Nature of a License of Intellectual Property	TRG discussions led to amended FASB guidance discussed in Chapter 8
	9	Distinct in the Context of the Contract	TRG discussions led to amended FASB guidance discussed in Section 4.2.1.2
	10	Contract Enforceability and Termination Clauses	Section 3.2
26 January 2015	11	October 2014 Meeting — Summary of Issues Discussed and Next Steps	Not applicable
	12	Identifying Promised Goods or Services	TRG discussions led to amended FASB guidance discussed in Section 4.1
	13	Collectibility	Section 3.1.5
	14	Variable Consideration	Section 5.2.3
	15	Noncash Consideration	TRG discussions led to amended FASB guidance discussed in Section 5.6
	16	Stand-Ready Obligations	Sections 4.1.1 & 7.1.4.3
	17	Islamic Finance Transactions	Not included
	18	Material Right	Questions in this paper were brought forward to agenda paper no. 37 for TRG discussion
	19	Consideration Payable to a Customer	Questions in this paper were brought forward to agenda paper no. 28 for TRG discussion

Date of TRG Meeting	Agenda Paper No.	Topic Discussed	FRD Section
	20	Significant Financing Component	Questions in this paper were brought forward to agenda paper no. 30 for TRG discussion
	21	Licenses Research Update	No TRG discussion — update only
	22	Performance Obligations Research Update	No TRG discussion — update only
	23	Costs to Obtain a Contract	Sections 9.3 & 9.3.1 & 9.3.3
	24	Contract Modifications	TRG discussions led to amended FASB guidance discussed in Section 1.3
30 March 2015	25	January 2015 Meeting — Summary of Issues Discussed and Next Steps	Not applicable
	26	Contributions	Section 2.4
	27	Series of Distinct Goods or Services	Section 4.2.2
	28	Consideration Payable to a Customer	Sections 5.7 & 5.7.2
	29	Warranties	Section 9.1.1
	30	Significant Financing Component	Section 5.5.1
	31	Variable Discounts	Section 6.4
	32	Exercise of Material Right	Sections 4.6 & 5.8
	33	Partially Satisfied Performance Obligations	Sections 7.1.4.3 & 9.3.2
13 July 2015	34	March 2015 Meeting — Summary of Issues Discussed and Next Steps	Not applicable
	35	Accounting for Restocking Fees and Related Costs	Section 5.4.1
	36	Credit Cards	Section 2.4
	37	Consideration Payable to a Customer	Sections 5.7 & 5.7.2 & 5.7.3
	38	Portfolio Practical Expedient and Application of Variable Consideration Constraint	Sections 5.2.2 & 5.2.3 & 5.4.1
	39	Application of the Series Provision and Allocation of Variable Consideration	Sections 4.2.2 & 5.2.1 & 6.3
	40	Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation	Section 7.1.4.1 & 7.1.4.3
	41	Measuring Progress when Multiple Goods or Services are Included in a Single Performance Obligation	Section 7.1.4.3
	42	Completed Contracts at Transition	TRG discussions led to amended FASB guidance discussed in Section 1.3
	43	Determining When Control of a Commodity Transfers	Not included

Date of TRG Meeting	Agenda Paper No.	Topic Discussed	FRD Section
9 November 2015	44	July 2015 Meeting — Summary of Issues Discussed and Next Steps	Section 5.7.3
	45	Licenses — Specific Application Issues About Restrictions and Renewals	TRG discussions led to amended FASB guidance discussed in Sections 8.1.3 & 8.4
	46	Pre-Production Activities	Sections 4.1.1 & 9.3.2
	47	Whether Fixed Odds Wagering Contracts are Included or Excluded from the Scope of Topic 606	Section 2.4
	48	Customer Options for Additional Goods and Services	Sections 3.2 & 4.1.1 & 4.6
	49	November 2015 Meeting — Summary of Issues Discussed and Next Steps	Not applicable
18 April 2016	50	Scoping Considerations for Incentive-based Capital Allocations	Not included
	51	Contract Asset Treatment in Contract Modifications	Section 10.1
	52	Scoping Considerations for Financial Institutions	Section 2.4
	53	Evaluating How Control Transfers Over Time	Section 7.1.4.3
	54	Class of Customer	Section 4.6 & 10.4.2

H Summary of differences from IFRS

The following comparison of the US GAAP and IFRS standards was issued by the FASB and included as an appendix to ASU 2016-12. It is reproduced below in its entirety.

Comparison of Topic 606 and IFRS 15

A1. Topic 606, together with the IASB's IFRS 15, is a joint effort by the FASB and the IASB to improve financial reporting by creating common revenue recognition guidance for GAAP and IFRS that can be applied consistently across various transactions, industries, and capital markets. In Topic 606 and IFRS 15, the Boards achieved their goal of reaching the same conclusions on requirements for the accounting for revenue from contracts with customers. However, there are some minor differences, as follows:

a. Collectibility threshold — The Boards included an explicit collectibility threshold as one of the criteria that a contract must meet before an entity can recognize revenue. For a contract to meet that criterion, an entity must conclude that it is probable that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In setting the threshold, the Boards acknowledged that the term *probable* has different meanings in GAAP and IFRS. However, the Boards decided to set the threshold at a level that is consistent with previous revenue recognition practices and requirements in GAAP and IFRS (see paragraphs BC42–BC46 of Update 2014-09).

b. Interim disclosure requirements — The Boards noted that the general guidance in their respective interim reporting guidance (Topic 270, Interim Reporting, and IAS 34, *Interim Financial Reporting*) would apply to revenue from contracts with customers. However, the IASB decided to also amend IAS 34 to specifically require the disclosure of disaggregated information of revenue from contracts with customers in interim financial statements. The FASB similarly decided to amend Topic 270 to require a public entity to disclose disaggregated revenue information in interim financial statements. The FASB also decided to require that information about both contract balances and remaining performance obligations be disclosed on an interim basis (see paragraphs BC358–BC361 of Update 2014-09).

c. Early application and effective date — The effective date for IFRS 15 is for annual reporting periods beginning on or after January 1, 2018; whereas, Topic 606 has an effective date for public entities for annual reporting periods beginning after December 15, 2017. Early application is permitted for IFRS 15. Topic 606 also permits early application, but only as of annual reporting periods beginning after December 15, 2016.

d. Impairment loss reversal — Consistent with other areas of GAAP, Topic 340 does not allow an entity to reverse an impairment on an asset that is recognized in accordance with the guidance on costs to obtain or fulfill a contract. In contrast, IFRS 15 requires an entity to reverse an impairment, which is consistent with the requirements on the impairment of assets within the scope of IAS 36, *Impairment of Assets* (see paragraphs BC309–BC311 of Update 2014-09).

e. Nonpublic entity requirements — Topic 606 applies to nonpublic entities and includes some specific relief for nonpublic entities relating to disclosure, transition, and effective date. No such guidance is included in IFRS 15. IFRS for small- and medium- sized entities is available for entities that do not have public accountability (see paragraphs BC504–BC521 of Update 2014-09).

f. Determining the nature of an entity's promise in granting a license of intellectual property — Topic 606 and IFRS 15 require an entity to assess whether the nature of its promise in granting a license is a right to use or a right to access the entity's intellectual property, which results in point in time or over time revenue recognition, respectively. Under Topic 606, an entity makes this determination by classifying the intellectual property underlying the license as functional or symbolic on the basis of whether the intellectual property has significant standalone functionality. A license to functional intellectual property is considered a right to use, while a license to symbolic intellectual property is considered a right to access the underlying intellectual property. Under IFRS 15, determining whether the nature of an entity's promise in granting a license is a right to use or a right to access the entity's intellectual property is based on whether the customer can direct the use of and obtain substantially all of the remaining benefits from a license at the point in time the license is granted, which occurs if the underlying intellectual property is not significantly affected by the entity's ongoing activities. Although most licenses to symbolic intellectual property would be recognized over time under IFRS 15, revenue may be recognized at a point in time in those cases in which the entity will undertake no activities that significantly affect the ability of the customer to obtain benefit from the intellectual property during the license period. Under Topic 606, revenue for all licenses to symbolic intellectual property is recognized over time (over the license period or the remaining economic life of the intellectual property, if shorter) (see paragraphs BC51–BC65 of Update 2016-10.)

g. Renewals of licenses of intellectual property — Topic 606 specifies that a renewal or extension of a license is subject to the use and benefit guidance in paragraph 606-10-55-58C, which generally will result in revenue recognition at the beginning of the renewal period. Under IFRS 15, the use and benefit guidance (paragraph B61) does not explicitly refer to renewals. Consequently, in some cases, this may result in the recognition of revenue with respect to the renewal or extension at a later date under Topic 606 than under IFRS 15 (see paragraphs BC48–BC50 in Update 2016-10).

h. Shipping and handling activities — Topic 606 provides an accounting policy election that permits an entity to account for shipping and handling activities that occur after the customer has obtained control of a good as an activity to fulfill the promise to transfer the good. IFRS 15 does not contain a similar policy election (see paragraphs BC19–BC25 of Update 2016-10).

i. Noncash consideration — Topic 606 specifies that noncash consideration should be measured at estimated fair value at contract inception and that the variable consideration guidance applies only to variability resulting from reasons other than the form of the noncash consideration. IFRS 15 does not prescribe the measurement date and whether the variable consideration guidance applies only to variability resulting from reasons other than the form of the noncash consideration (see paragraphs BC36–BC43 of this Update).

j. Presentation of sales (and other similar) taxes — Topic 606 provides an accounting policy election that permits an entity to exclude all sales (and other similar) taxes from the measurement of the transaction price. IFRS 15 does not contain a similar policy election (see paragraphs BC29–BC35 of this Update).

k. Date of application of the contract modifications practical expedient (modified retrospective transition) — For an entity applying Topic 606 in accordance with paragraph 606-10-65- 1(d)(2) (equivalent to paragraph C3(b) of IFRS 15), an entity should apply the practical expedient at the date of initial application. However, an entity applying IFRS 15 in accordance with paragraph C3(b) may apply the practical expedient either (1) at the beginning of the earliest period presented or (2) at the date of initial application (see paragraphs BC44–BC48 of this Update).

l. Completed contracts at transition — Topic 606 defines *completed contract* as a contract for which all (or substantially all) of the revenue has been recognized under legacy GAAP before the date of initial application. IFRS 15 defines *completed contract* as one for which an entity has transferred all goods or services identified in accordance with existing IFRS. Furthermore, the IASB added a practical expedient to allow an entity applying the full retrospective method of transition (paragraph C3[a] of IFRS 15) not to restate contracts that are completed contracts at the beginning of the earliest period presented. Topic 606 does not contain this practical expedient (see paragraphs BC49–BC53 of this Update).

A2. Topic 606 and IFRS 15 include different articulations of the guidance in the following areas:

a. Collectibility criterion — The guidance in Topic 606 explains that the objective of the collectibility threshold is to determine if there is a substantive transaction based on whether the customer has the ability and intention to pay the promised consideration in exchange for goods or services that will be transferred to the customer (rather than assessing collectibility of the consideration promised in the contract for all of the promised goods or services). Additional guidance (including examples) on the application of the collectibility threshold is included in the implementation guidance in Topic 606. This guidance is not included in IFRS 15 (see paragraphs BC9–BC20 of this Update).

b. Revenue recognition for contracts with customers that do not meet the criteria for Step 1 — Topic 606 includes an additional criterion for revenue recognition compared with IFRS 15 when a contract does not meet the criteria in paragraph 606-10-25-1. The additional criterion allows an entity to recognize revenue in the amount of consideration received when the entity has transferred control of the goods or services, the entity has stopped transferring goods or services (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable (see paragraphs BC21–BC28 of this Update).

c. Promised goods or services — The guidance in Topic 606 states that items that are immaterial in the context of the contract are not required to be assessed as promised goods or services for purposes of identifying performance obligations. IFRS 15 does not include a similar provision. Entities applying IFRS should consider the overall objective of IFRS 15 and materiality considerations in assessing promised goods or services and identifying performance obligations (see paragraphs BC8–BC18 of Update 2016-10).

d. When to consider the nature of an entity's promise in granting a license — Topic 606 explicitly states that when a single performance obligation includes a license of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time and in selecting an appropriate method for measuring progress. Under IFRS 15, the requirement to specifically consider the nature of a license included in a single performance obligation that contains one or more other goods or services is less explicit (see paragraphs BC66–BC69 of Update 2016-10).

e. Contractual restrictions in a license and identifying performance obligations — Topic 606 explicitly states that contractual provisions that, explicitly or implicitly, require the entity to transfer control of additional goods or services to the customer (for example, by requiring the entity to transfer control of additional rights of use or rights of access that the customer does not already control) should be distinguished from contractual provisions that, explicitly or implicitly, define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its performance obligation at a point in time or over time. While this guidance is not included in IFRS 15, the basis for conclusions in IFRS 15 explains that the licensing implementation guidance does not override the revenue recognition model, and an entity is expected to apply the general requirements for identifying performance obligations to identify whether a contract includes one or multiple licenses (see paragraphs BC41–BC47 of Update 2016-10).

A3. Topic 606 and IFRS 15 were structured to be consistent with the style of the Codification and other standards in IFRS, respectively. As a result, the paragraph numbers of Topic 606 and IFRS 15 are not the same. The wording in most of the paragraphs is consistent because Topic 606 and IFRS 15 were issued as common revenue guidance for GAAP and IFRS. However, as noted in paragraphs A1 and A2, the wording in some paragraphs differs. The following table illustrates how the paragraphs of IFRS 15 and Topic 606, and the related illustrative examples, correspond. Paragraphs for which the wording differs are indicated with an asterisk (*):

Main features	Overview and background
N/A	606-10-05-1
IN7	606-10-05-2
IN8	606-10-05-3
IN8	606-10-05-4
IN9	606-10-05-5
N/A	606-10-05-6
Objectives	
1	606-10-10-1
> Meeting the objective	
2	606-10-10-2
3	606-10-10-3
4	606-10-10-4
Scope and scope exceptions	
> Entities	
N/A	606-10-15-1
> Transactions	
5	606-10-15-2
6	606-10-15-3
7	606-10-15-4
8	606-10-15-5
Recognition	
> Identifying the contract	
9	606-10-25-1*
10	606-10-25-2
11	606-10-25-3*
12	606-10-25-4
13	606-10-25-5
14	606-10-25-6
15	606-10-25-7*
16	606-10-25-8
> Combination of contracts	
17	606-10-25-9

> Contract modifications	
18	606-10-25-10
19	606-10-25-11
20	606-10-25-12
21	606-10-25-13
> Identifying performance obligations	
22	606-10-25-14
23	606-10-25-15
> > Promises in contracts with customers	
24	606-10-25-16*
N/A	606-10-25-16A
N/A	606-10-25-16B
25	606-10-25-17*
> > Distinct goods or services	
26	606-10-25-18
N/A	606-10-25-18A
N/A	606-10-25-18B
27	606-10-25-19
28	606-10-25-20
29	606-10-25-21
30	606-10-25-22
> Satisfaction of performance obligations	
31	606-10-25-23
32	606-10-25-24
33	606-10-25-25
34	606-10-25-26
> > Performance obligations satisfied over time	
35	606-10-25-27
36	606-10-25-28
37	606-10-25-29
> > Performance obligations satisfied at a point in time	
38	606-10-25-30
> > Measuring progress toward complete satisfaction of a performance obligation	
39	606-10-25-31
40	606-10-25-32
> > > Methods for measuring progress	
41	606-10-25-33
42	606-10-25-34
43	606-10-25-35
> > > Reasonable measures of progress	
44	606-10-25-36
45	606-10-25-37
Measurement	
46	606-10-32-1
> Determining the transaction price	
47	606-10-32-2
N/A	606-10-32-2A
48	606-10-32-3
49	606-10-32-4

> > Variable consideration	
50	606-10-32-5
51	606-10-32-6
52	606-10-32-7
53	606-10-32-8
54	606-10-32-9
> > > Refund liabilities	
55	606-10-32-10
> > > Constraining estimates of variable consideration	
56	606-10-32-11
57	606-10-32-12
58	606-10-32-13
> > > Reassessment of variable consideration	
59	606-10-32-14
> > The existence of a significant financing component in the contract	
60	606-10-32-15
61	606-10-32-16
62	606-10-32-17
63	606-10-32-18
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67	606-10-32-22
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N/A	606-10-55-98D
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N/A	606-10-55-98F
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IE295	606-10-55-381*
IE296	606-10-55-382*
Example 58 — Access to intellectual property	
IE297	606-10-55-383*
IE298	606-10-55-384
IE299	606-10-55-385*
IE300	606-10-55-386*
IE301	606-10-55-387*
IE302	606-10-55-388*
Example 59 — Right to use intellectual property	
IE303	606-10-55-389
IE304	606-10-55-390
IE305	606-10-55-391*
IE306	606-10-55-392*
N/A	606-10-55-392A
N/A	606-10-55-392B
N/A	606-10-55-392C
N/A	606-10-55-392D
Example 60 — Sales-based royalty promised in exchange for a license of intellectual property and other goods or services	
IE307	606-10-55-393
IE308	606-10-55-394
Example 61 — Access to intellectual property	
IE309	606-10-55-395
IE310	606-10-55-396*
IE311	606-10-55-397*
IE312	606-10-55-398*
IE313	606-10-55-399*
Example 61A — Right to use intellectual property	
N/A	606-10-55-399A
N/A	606-10-55-399B
N/A	606-10-55-399C
N/A	606-10-55-399D
N/A	606-10-55-399E
N/A	606-10-55-399F
N/A	606-10-55-399G
N/A	606-10-55-399H
N/A	606-10-55-399I
N/A	606-10-55-399J
Example 61B — Distinguishing multiple licenses from attributes of a single license	
N/A	606-10-55-399K
N/A	606-10-55-399L

N/A	606-10-55-399M
N/A	606-10-55-399N
N/A	606-10-55-399O
Repurchase agreements	
IE314	606-10-55-400
Example 62 — Repurchase agreements	
IE315	606-10-55-401
IE316	606-10-55-402
IE317	606-10-55-403
IE318	606-10-55-404
IE319	606-10-55-405
IE320	606-10-55-406
IE321	606-10-55-407
Bill-and-hold arrangements	
IE322	606-10-55-408
Example 63 — Bill-and-hold arrangement	
IE323	606-10-55-409
IE324	606-10-55-410
IE325	606-10-55-411
IE326	606-10-55-412
IE327	606-10-55-413

I Glossary

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Glossary

606-10-20

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Contract Asset

An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Contract Liability

An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Customer

A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Lease

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Performance Obligation

A promise in a contract with a customer 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.

Probable (second definition)

The future event or events are likely to occur.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion. An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Revenue

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Standalone Selling Price

The price at which an entity would sell a promised good or service separately to a customer.

Transaction Price

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

EY | Assurance | Tax | Transactions | Advisory

SCORE no. BB3043
(Revised August 2016)

12 December 2016

2016 AICPA National Conference on Current SEC and PCAOB Developments

Compendium of significant accounting and reporting issues

In this issue:

Summary

Representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) (collectively, the Boards) and the Public Company Accounting Oversight Board (PCAOB) shared their views on various accounting, financial reporting and auditing issues at the annual AICPA National Conference on Current SEC and PCAOB Developments (Conference) last week in Washington, DC.

Highlights included:

New accounting standards — The chairmen of the FASB and IASB discussed implementation efforts related to the significant new accounting standards on revenue, leases and financial instruments under both US GAAP and IFRS. Members of the SEC staff also discussed recent consultations related to implementation of the new standards, including their approach in evaluating the questions. The SEC staff stressed the importance of timely implementation efforts and robust disclosure that communicates how a company will be affected by the new standards and the status of its implementation efforts.

Non-GAAP financial measures — Regulators, standard setters, investors and preparers shared their perspectives on the use and disclosure of non-GAAP financial measures. Members of the SEC staff said companies have made significant progress in complying with the interpretations the staff updated in May 2016. They also discussed their views on specific measures and adjustments, as well as presentations that might give non-GAAP measures undue prominence. Standard setters discussed how and why investors use alternative performance measures and whether revisions to current presentation and disclosure requirements may be warranted to better meet the needs of investors. The PCAOB staff is monitoring the need for greater auditors' involvement with non-GAAP information derived from the audited financial statements, with input from the PCAOB's advisory groups.

Building a better working world

Upcoming changes — Overall, change was the common theme at the Conference. Corporate executives spoke about their efforts to implement the major new accounting standards on revenue and leases, and the anticipated ongoing effects on resources, systems and processes. Staff members from the SEC Division of Corporation Finance (DCF) spoke about the future of the Commission's disclosure effectiveness initiative and other rulemaking activities. And PCAOB Chairman James Doty discussed the enhanced research and stakeholder outreach that the PCAOB is incorporating into its standard setting process. The PCOAB is also nearing completion of its proposed standard to redesign and modernize the audit report.

Remarks of senior representatives

Remarks by Wesley Bricker, Chief Accountant

SEC Chief Accountant Wesley Bricker focused his remarks on the importance of cooperation and coordination to advance high quality financial reporting in the US capital markets. Specifically, he focused on the roles of preparers, audit committees, auditors and standard-setters in advancing that shared responsibility.

‘Investors look to [preparers] to evaluate, challenge, and ultimately address transactions, judgments, and risk areas with accurate and informative disclosures. Effective internal control supports your work.’

— Wesley Bricker, Chief Accountant

Role of preparers

Mr. Bricker said that high-quality financial reporting begins with preparers. Strong and effective internal controls and rigorous independent audits are necessary for companies to communicate reliable financial information to investors so they can raise necessary capital. Deficiencies in internal control over financial reporting (ICFR) can lead to lower quality financial reporting and, ultimately, higher restatement rates and a higher cost of capital. It will be important for companies to update and maintain effective internal controls as they implement the significant new accounting standards on revenue, leases, financial instruments and credit losses, which Mr. Bricker referred to as the "new GAAP standards."

Mr. Bricker encouraged preparers to implement the new GAAP standards in a timely manner, provide useful transition disclosures and adhere to the objectives of the new guidance. Regarding the new revenue standard, he commented that revenue is one of the single most important measures used by investors in assessing a company's performance. Given market expectations of comparability, companies cannot afford to "get the accounting for revenue wrong."

Consistent with Staff Accounting Bulletin (SAB) Topic 11.M, Mr. Bricker reiterated that the SEC staff expects registrants to disclose how they will be affected by Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers* (ASC 606) and the other new GAAP standards as they make progress on implementation. For example, the SEC staff expects registrants to make more specific quantitative and qualitative disclosures in 2016 annual reports and in their 2017 periodic reports about the effects (quantitative or qualitative) of adopting the new revenue standard.

While Mr. Bricker observed that most companies have made progress on ASC 606 implementation since last year's Conference, he believes there is more to do. He encouraged companies that are behind in their implementation of the revenue standard to discuss the reasons for the delay with their audit committee and auditor. He also suggested that those companies provide enhanced disclosures about their implementation status in addition to the disclosures required by SAB Topic 11.M.

Mr. Bricker also said the staff of the Office of the Chief Accountant (OCA) has been working with companies on prefiling submissions on accounting positions related to the adoption of the new GAAP standards. When forming its conclusions, the staff of OCA considers the nature, design and substance of the transaction, the standard setter's basis for conclusions, relevant discussions by groups such as the Transition Resource Group (TRG) for Revenue

Recognition and the objectives of consistency and comparability. Mr. Bricker emphasized that it is important for preparers to fully understand the registrant's contracts with customers in order to clearly articulate the basis for the proposed accounting under the new standard. He also reminded the audience that similar considerations apply for the other new GAAP standards.

Mr. Bricker said that substantial progress has been made over the past year in addressing many of the problematic practices related to disclosures of non-GAAP financial measures. However, he still believes companies can further improve their evaluation of the appropriateness of particular non-GAAP measures, the prominence of their presentation and the effectiveness of the registrant's disclosure controls and procedures (DCP). Mr. Bricker encouraged audit committee members to understand management's judgments about the use of non-GAAP measures and how the company's approach differs from those followed by other companies.

Role of audit committees

Audit committees are critical to reliable financial reporting, and Mr. Bricker encouraged audit committee members to stay current on emerging issues and engage outside expert advisers when necessary. He also stressed the importance of the audit committee's relationship with the auditor in overseeing management's activities. To promote better communication, he suggested that audit committee members pose the following questions to auditors:

- If you were management and were solely responsible for preparing the company's financial statements, would the financial statements have in any way been prepared differently?
- If you were an investor, would you believe that you received the information you needed to understand the company's financial position and performance?
- Is the company following the same ICFR and internal audit procedures that would be followed if you were the chief executive officer?
- Have you made any recommendations that management has not followed?

Mr. Bricker also emphasized the audit committee's role in overseeing the terms of the audit engagement and the auditor's compensation. In particular, he recommended that audit committees make sure that an issuer's cost-cutting initiatives don't adversely affect audit scope, staffing or compensation. He also warned that normal corporate procurement policies and procedures may be inappropriate for auditor selection, retention and compensation.

Mr. Bricker said he was encouraged by audit committees' voluntary reporting, which was highlighted in a recent EY survey.[1]

Auditors and their independence

Auditors are the key gatekeepers for high-quality financial reporting, and Mr. Bricker emphasized the importance of rigorous and objective audits by independent auditors. Mr. Bricker reminded auditors of the general standard of independence,[2] adding that both auditors and audit committees should review their policies to make sure that the standard is met. Mr. Bricker also reminded auditors to remain aware of limitations on involvement with their clients' activities in implementing the new GAAP standards.

Role of the PCAOB

Mr. Bricker commended the PCAOB for the ongoing improvements to its inspection program and its decision to implement a new research agenda. He encouraged the PCAOB to continue to advance and finalize other important and challenging projects on its standard-setting agenda, including auditing accounting estimates.

Role of the FASB and IASB

Standard setters play an important role in assuring that new standards result in objective, neutral and useful information about economic activities even if the updated information affects the business decisions of market participants. Mr. Bricker commended both the FASB and IASB on their standard-setting activities for the benefit of investors and emphasized how important it is for the Boards to respond to investors' needs in a timely manner and to effectively use post-implementation reviews.

Mr. Bricker stated that his staff monitors the development of IFRS standards and interprets their application through the consultation process, thus integrating IFRS into all aspects of OCA's work. At the same time, he believes that for the foreseeable future, US GAAP will continue to best serve the needs of investors and other users who rely on financial reporting by US issuers. Mr. Bricker said it is worth continuing to consider his predecessor's proposal to allow domestic issuers to provide IFRS-based information as a supplement to their US GAAP financial statements without reconciliation as a non-GAAP measure.

Remarks by Russell Golden, Chairman of the FASB

FASB Chairman Russell Golden, who was recently appointed to another term ending in 2020, discussed the five priorities he set when he became Chairman in 2013: improvements, implementation, ideals, inclusiveness and international, which he referred to as the five "I's."

'Technology gives us our greatest opportunity to improve financial reporting.'

– Russell Golden, FASB Chairman

Improvements

Mr. Golden said the Board has improved US GAAP by completing several major projects. He called the new revenue recognition standard a major achievement in the Board's efforts to improve and converge US GAAP with IFRS on an important area of financial reporting that affects all companies. The new leases standard will result in a more faithful representation of leasing activities because it requires lessees to recognize most leases on their balance sheets. The current expected credit loss (CECL) model in the new credit loss standard also represents an improvement to today's "incurred loss" approach. Mr. Golden also said the FASB's simplification initiative has succeeded in reducing costs for preparers without compromising the quality of information provided to investors.

Mr. Golden said the FASB plans to continue improving US GAAP by issuing final standards in 2017 on hedge accounting and the accounting for long-duration contracts issued by insurers (e.g., life insurance, annuities). The FASB also plans to issue final standards on classifying debt as current or noncurrent and the accounting for non-employee share-based payment awards.

Mr. Golden said the Board received valuable feedback on its Invitation to Comment on future agenda priorities. Mr. Golden noted that some constituents said the Board should slow down on new projects until stakeholders have the chance to implement the major new standards, and the Board will consider this feedback when determining how to manage the pace of change while continuing to improve US GAAP.

How we see it

Over the next few years, we believe that the Board should focus its efforts on monitoring implementation of the new standards, completing major projects, including the Conceptual Framework, addressing additional issues that may arise and completing targeted improvements already on its agenda rather than beginning any major new projects.

Implementation

The FASB has taken a more proactive approach to support the implementation of new accounting standards. Mr. Golden commented on the success of the TRG for Revenue Recognition in which various stakeholders around the globe were involved. Mr. Golden said input from these stakeholders helped the Board quickly identify issues that could have led to diversity in practice. Based on that success, the Board convened a TRG on credit losses to address implementation issues before it issued that final standard. Members of that TRG were able to weigh in on the draft guidance, which Mr. Golden said should reduce the need to make technical corrections later.

Mr. Golden said the FASB did not create a TRG for the new leases standard because, in the Board's view, the changes in lease accounting are not as significant as revenue recognition and credit losses. He noted, however, that the FASB staff is monitoring the questions that are arising about implementation of the new leases standard and stands ready to address them.

Inclusiveness

Mr. Golden said the Board is making standard setting more inclusive by focusing on gaining a better understanding of the differences between large and small public companies, nonpublic companies and not-for-profit organizations and when those differences require different accounting. The FASB also has promoted inclusiveness through its outreach and through the introduction of new, plain English communications materials.

'By improving our economic analysis of standards under development, we can have greater confidence that the benefits of those new standards will justify their costs.'

– James Doty, PCAOB Chair

Ideals

The FASB continues to focus on its foundational projects on the conceptual framework and the disclosure framework. The conceptual framework gives the Board a starting point for addressing an accounting issue. The disclosure framework would serve a similar function, providing the FASB with a consistent methodology for approaching decisions about disclosures. Mr. Golden emphasized that the objective of the disclosure framework project is making disclosures more meaningful, not necessarily reducing the volume of disclosures.

International

Mr. Golden said the FASB continues to collaborate with the IASB and other international standard setters. The FASB has contributed to improving IFRS through its membership in the IASB's Accounting Standards Advisory Forum, and the FASB has met with standard setters from Canada, Japan, China, Korea and other nations to share ideas on how to improve accounting standards. The FASB expects to have joint meetings with these standard setters in 2017 to talk about priorities and future initiatives.

Mr. Golden reiterated that the completion of the joint revenue recognition standard by the FASB and the IASB will contribute to more comparable global accounting standards. Although the Boards reached different conclusions on certain aspects of the leases and credit losses standards, Mr. Golden emphasized that the Boards agree on the important principles that most leases belong on the balance sheet and that a more forward-looking model for credit losses is needed.

Remarks by James Doty, Chairman of the PCAOB

Mr. Doty said the PCAOB "has a unique and indispensable role in helping companies maintain investor trust, avoid financial reporting failures, and in turn has helped our economy and capital markets remain resilient and grow." He also said that the PCAOB has improved the overall landscape by improving audits and by changing firms' mindsets and execution.

Mr. Doty said that the PCAOB has forged a constructive relationship with audit firms, "albeit a somewhat adversarial one." Such a relationship "benefits our economic system, protects investors, provides clarity on essential standards, helps companies stay on track and contributes to capital formation," he said.

Inspections update

Mr. Doty said that the "issuance of regular inspection reports provides meaningful information that didn't exist before, and that helps all parties, including investors, audit committees, and companies, make better decisions." To preview its 2015 inspection findings and describe the scope and objectives of 2016 inspections of audits of public companies and broker-dealers, the PCAOB issued Staff Inspection Briefs this year. The PCAOB also issued its fifth annual inspection report on the temporary broker-dealer program, and Mr. Doty said the Board plans to develop a proposal for a permanent program based on the insights gained through past inspection cycles.

Improvements to the PCAOB's standard-setting process and other outreach efforts

Mr. Doty provided an overview of the PCAOB's standard-setting activities and discussed improvements the PCAOB has made to its process to issue "better and clearer standards related to the performance of audits." He also noted that the PCAOB created a research agenda to allow the PCAOB staff to perform "deeper research before embarking on new projects as well as enhancing outreach at all stages."

In 2016, the PCAOB continued to increase its outreach efforts to audit committees to enhance the Board's awareness of audit risks and challenges. The PCAOB also met with preparers, auditors and SEC staff members to understand challenges they have faced in assessments of ICFR. Finally, Mr. Doty noted that the PCAOB was nearing completion of its project to make the auditor's report more informative, and he highlighted some of the benefits that have been expressed by stakeholders in other jurisdictions that have implemented similar requirements.

'[DCF staff] will begin issuing comments on these [transition] disclosures when they are materially deficient.'

– Cicely LaMothe, Associate Director in the Division of Corporation Finance

PCAOB Center for Economic Analysis

Mr. Doty also discussed the PCAOB's efforts to build its capabilities in research and economic analysis through the Center for Economic Analysis (Center). Mr. Doty said the Center is evaluating both the potential effect of proposed rules and the effects of rules and audit standards the PCAOB has issued. "By improving our economic analysis of standards under development, we can have a greater confidence that the benefits of those new standards will justify their costs," he said. Mr. Doty also noted that the Center issued for public comment the PCAOB's first post-implementation review analyzing the effect of Auditing Standard (AS) 7, *Engagement Quality Review*. The Center also is studying many of the potential audit quality indicators on which the PCAOB sought comment in 2015.

Accounting and disclosure matters

New accounting standards

Transition disclosures

Sylvia Alicea, a staff member in OCA, reminded registrants that they need to disclose the effect of adopting new accounting standards in future periods in accordance with SAB Topic 11.M. She said that if a registrant does not know or cannot reasonably estimate the effect that the adoption of a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help the reader assess the potential significance of the effect on the registrant's financial statements. These qualitative disclosures should include a description of the new standard's effect on the registrant's accounting policies and provide a comparison to the registrant's current accounting policies.

Jenifer Minke-Girard, Assistant Deputy Chief Accountant in OCA, said that in addition to the requirements of SAB 11.M, companies should consider qualitative disclosures that include a description of the process they are using to assess the effect of the new standard, where they are in the implementation process, what matters still need to be addressed and what additional steps they plan to take.

SEC staff members offered the following observations on transition disclosures:

- A registrant should not be reluctant to disclose reasonably estimable quantitative information (even if it's only for a subset of the registrant's arrangements such as one product category or revenue stream) merely because the ultimate effect of adoption may differ from the information disclosed.
- If a registrant's transition disclosures were prepared based on the best information available at the time and that information subsequently changes, the resulting change in disclosure would likely not indicate the existence of a control deficiency. However, if transitional disclosures are based on information that may subsequently change, the registrant should include a statement that the disclosures are preliminary in nature.
- Transition disclosures should be consistent with other information provided to the audit committee and investors, and the disclosures should be subject to effective ICFR.

How we see it

In addition to the disclosures discussed above, companies should consider the need for Management's Discussion and Analysis (MD&A) disclosures that discuss the effect the standards may have on their business (e.g., expected changes in contract arrangements, effect compliance with debt covenants).

Ernst & Young LLP (EY) resources

- *Financial reporting developments, Revenue from contracts with customers (ASC 606)* (SCORE No. BB3043)

Revenue recognition

Ms. Alicea and Ruth Uejio, staff members in OCA, discussed several matters related to the new revenue standard.

Definition of a contract

Certain contracts may be executed as part of a loss leader strategy in which a good is sold at a loss with an expectation that future sales contracts will result in higher sales and/or profits. In determining whether these anticipated contracts should be part of the accounting for the existing loss leader contract, Ms. Alicea observed that the definition of a contract in ASC 606 is based on enforceable rights and obligations in the existing contract. While it may be likely that the customer will enter into a future contract or the customer may even be compelled economically or by regulation to do so, it would not be appropriate to account for an anticipated contract due to the absence of enforceable rights and obligations.

Contract combination

The combination guidance in ASC 606 explicitly limits which contracts may be combined to those with the same customer or related parties of the customer. The SEC staff objected to extending the contract combination guidance beyond those parties even though other criteria for combination were met.

Consideration paid or payable to a customer

Ms. Uejio discussed accounting under the new revenue standard for payments made to customers. Given there are many reasons why a company may make payments to its customers, the accounting conclusions will depend on specific facts and circumstances. A company must first determine why the payment was made to determine its nature and substance, she said.

The staff in OCA would consider the following questions when evaluating the accounting for payments made to a customer under ASC 606:

- What are the underlying economic reasons for the transaction? Why is the payment being made?
- How did the company communicate and describe the nature of the customer payment to its investors?
- What do the relevant contracts governing the payment stipulate? Does the payment secure an exclusive relationship between the parties? Does the payment result in the customer committing to make a minimum level of purchases from the vendor?
- What is the accounting basis for recognizing an asset or recognizing an up-front payment immediately through earnings?

Once a company has determined the substance of the payment, a company should account for the payment using an accounting model that is consistent with the identified substance of the payment and relevant accounting literature, Ms. Uejio said. In doing this, companies should carefully and impartially evaluate all of the facts and circumstances and establish accounting policies that are consistently applied. In addition, Ms. Uejio expressed her view that matching the cost of the payment to the anticipated future revenue is not a determinative factor to support asset recognition for an up-front payment made to a customer.

Gross versus net presentation

Under the new revenue standard, an entity is a principal and therefore records revenue on a gross basis if it controls a specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services.

Ms. Uejio said that the determination of whether a company is the principal or the agent could be challenging for evolving business models and could be different from the conclusion reached under current US GAAP. In adopting ASC 606, companies should revisit their current principal versus agent conclusions based on whether they control the specified good or service before it is transferred to the customer.

Ms. Uejio cautioned against viewing either gross or net reporting as a default or a safe harbor. Instead, the specific facts and circumstances of an arrangement should drive the final accounting conclusion. Finally, Ms. Uejio said that the disclosures related to the principal versus agent determination are important because they allow investors to understand the registrant's role in the arrangement.

How we see it

Consistent with legacy US GAAP, entities will need to carefully evaluate whether a gross or net presentation is appropriate. While the new standard includes guidance that is similar to legacy GAAP, the key difference is that the new guidance focuses on control of the specified goods and services as the overarching principle for entities to consider in determining whether they are acting as a principal or an agent. This could result in entities reaching different conclusions than they do under legacy GAAP.

SAB Topic 13

Ms. Alicea said SAB Topic 13, *Revenue recognition,* will continue to apply to registrants prior to the adoption of the new revenue standard. However, for implementation-related consultations, the SEC staff's starting point is the new revenue standard, and registrants should apply ASC 606 instead of SAB Topic 13 when evaluating the post-adoption accounting for their revenue arrangements.

Disclosure matters

Cicely LaMothe, Associate Director in DCF, cautioned registrants that the staff will look outside of the financial statements (e.g., investor presentations, earnings releases, financial information reviewed by the chief operating decision maker (CODM)) to determine the adequacy of the disclosures of disaggregated revenue required by ASC 606-10-50 (e.g., disaggregation by type of goods or services, geographical region, customer).

EY resources

- *Technical Line, A closer look at the new credit impairment standard* (SCORE No. 03320-161US)

Credit losses

Sean May, a staff member in OCA, said that, given the wide range of financial assets that are affected by the new standard on credit losses, virtually every registrant will be affected. Mr. May encouraged registrants to start the implementation process early. He said the standard does not specify a "one-size-fits all" method for measuring expected credit losses, and he encouraged registrants to identify challenging implementation issues.

Mr. May also said that the guidance in Financial Reporting Release No. 28[3] and SAB No. 102[4] will continue to be relevant, given the need to incorporate reasonable and supportable forecasts in applying the new standard. He emphasized that in planning for implementation of the new standard, registrants engaged in lending activities should be preparing to support their expected credit loss estimates by documenting the systematic methodology they plan to apply, including the rationale supporting each reporting period's conclusion that these estimates are consistent with the principles of the standard.

Susan Cosper, FASB Technical Director and Chair of its Emerging Issues Task Force, highlighted some implementation activities relating to the credit losses standard. No implementation issues have been submitted for consideration by the TRG to date. The FASB staff has responded to technical inquiries seeking clarification about the standard's requirements, which were mostly confirmatory in nature regarding acceptable methodologies for determining expected credit losses.

Leases

Ms. Cosper discussed questions the FASB has received to date on implementation of the new leases standard, most of which relate to lessee accounting and transition. She said the FASB has not received many questions on the definition of a lease, which was surprising given the increased focus under the new standard on the definition of a lease.

No questions or issues raised to date have required formal standard setting. In the absence of a TRG, Ms. Cosper said a majority of the implementation questions have been raised by representatives of a professional accounting association, but questions also have been raised by large accounting firms and through the FASB's technical inquiry service.

Ms. Uejio said OCA has consulted with registrants on implementation questions and is actively monitoring the activities of stakeholders to understand how implementation issues will be addressed. She encouraged preparers, accounting firms and others to continue to work together to achieve consistent application of the new standard. She also emphasized the importance of ICFR and said it will be a key factor for preparers in arriving at well-reasoned judgments that are grounded in the principles of the new leases standard.

EY resources

Technical Line, A closer look at the new guidance on classifying and measuring financial instruments (SCORE No. BB3145)

Financial instruments recognition and measurement

Brian Staniszewski, a staff member in OCA, shared observations about implementation of the new standard on classifying and measuring financial instruments.[5] The new standard, among other things, requires entities that elect the fair value option in ASC 825, *Financial Instruments*, for financial liabilities, to present the change in fair value caused by a change in instrument-specific credit risk (i.e., the entity's own credit risk) separately in OCI.

Mr. Staniszewski discussed the applicability of the new standard to hybrid financial liability instruments such as a debt obligation that is indexed to the price of gold and requires cash settlement. Rather than bifurcating the embedded gold derivative under ASC 815,[6] the entity makes an irrevocable election under ASC 815[7] to initially and subsequently measure the entire hybrid financial liability at fair value through earnings. Mr. Staniszewski stated that US GAAP does not prescribe a sequence that must be followed when making a fair value election pursuant to ASC 815 or ASC 825. As such, he believes an entity that elects the fair value option under either guidance for an eligible hybrid instrument should follow the presentation requirements in the new guidance related to presenting a change in instrument-specific credit risk. Moreover, because the fair value of the instrument described in the example above would be affected by the price of gold, Mr. Staniszewski believes that use of the "base market risk method" (described in ASC 825-10-45-5) would not faithfully represent the portion of the total change in fair value attributable to instrument-specific credit risk.

Mr. Staniszewski also discussed the application of the new presentation guidance to nonrecourse financial liabilities. A nonrecourse financial liability is an instrument for which the payment is solely tied to the value or cash flows of an asset(s) pledged as collateral. That is, there is no recourse to the debtor. The risk of nonpayment, and the corresponding changes in the financial liability's fair value, are directly affected by the risk attributable to the performance of the underlying assets. In this fact pattern, Mr. Staniszewski believes that no portion of the change in the nonrecourse financial liability's fair value would be attributable to instrument-specific credit risk. Therefore, the entire change in fair value would be reported in earnings.

Insurance disclosures

Craig Olinger, Deputy Chief Accountant in DCF, discussed how insurance companies should present material acquisitions, dispositions and foreign currency in the claims development tables required by Accounting Standards Update (ASU) 2015-09, which does not prescribe specific requirements for such transactions or foreign currency translation.

Mr. Olinger said that retrospectively restating the claims development tables for material acquisitions generally would achieve the objectives of ASU 2015-09 while reflecting the acquisitions prospectively from the acquisition date might not. If registrants nevertheless choose to use a prospective approach to depict the acquired business, separate claims development tables should be presented for the acquired liabilities and the registrants' existing business, said Mr. Olinger. He also stressed that registrants should carefully evaluate the definition of accident year under the new standard, and depicting the year of acquisition as the accident year for acquired liabilities would not be consistent with that definition.

For material dispositions, Mr. Olinger said a retrospective approach that removes the disposed business from the claims development tables would be consistent with the objectives of the new standard to reflect liabilities that exist at the most recent balance sheet date.

As for the effect of foreign currency exchange rates, Mr. Olinger said that recasting all of the data in the claims development tables using current-period exchange rates or presenting separate claims development tables by each functional currency would be consistent with the objectives of the new standard. In his view, the use of multiple foreign currency translation rates may not be appropriate because it could distort trends and other useful information.

Mr. Olinger said insurance companies do not need to continue to disclose a consolidated 10-year claims development table in MD&A once they begin disclosing the claims development tables required by ASU 2015-09, and the staff has updated its Financial Reporting Manual to reflect this view.[8]

Reporting considerations for new standards

Nili Shah, Deputy Chief Accountant in DCF, explained how a company's adoption of a new accounting standard will affect registration statements filed or amended in the year of adoption. In new or amended registration statements filed after reporting the first interim period reflecting adoption of the new standard, companies that use the full retrospective transition method to adopt ASC 606 must provide retrospectively recasted financial statements for the most recent annual periods required to be included (or incorporated by reference). This would not apply if a company uses the modified retrospective method because it does not require recasting any periods before the date of adoption.

While the same requirements also apply to new or amended registration statements filed after a company adopts the leasing standard, the modified retrospective transition provisions in ASC 842, *Leases,* limit recasting to the date of initial application, which is defined as the beginning of the earliest comparative period presented in the year of adoption. As a result, only the most recent two years (one year for a smaller reporting company) would need to be retrospectively revised for purposes of the registration statement.

While the SEC does not intend to change the registration form requirements to eliminate or modify this requirement, the SEC staff did highlight that ASC 250-45-5 related to accounting changes provides an exception if retrospective revision is impracticable. While preclearance would not be required to rely on the exception, DCF-OCA staff is available to discuss fact patterns with companies.

Keith Higgins, Director of DCF, highlighted that the SEC staff would not object if companies and their securities counsel conclude that the adoption of new accounting standards like revenue and leasing are not "fundamental changes" for purposes of drawing on an effective shelf registration statement. A fundamental change would require a post-effective amendment to the shelf registration statement, which would trigger the need to recast as discussed above.

Existing accounting standards

Accounting policies

ASC 250[9] provides guidance on the accounting for and reporting of accounting changes. ASC 250 is clear that once an accounting principle is adopted, it must be used consistently in accounting for similar events and transactions. An entity may change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable.

Mr. May said that OCA has had recent consultations with registrants that, unrelated to the adoption of a new ASU, applied an alternative accounting policy to certain new transactions or events. He observed that judgment is required when determining whether transactions or events are clearly different in substance from those occurring in the past and could warrant adoption of a new accounting principle rather than applying an existing accounting principle. Mr. May emphasized the following:

- Clear documentation regarding the nature of the transactions or events that resulted in the existing accounting policy is the starting point of the analysis
- Determining whether transactions or events are clearly different in substance from those occurring in the past requires judgment

- That identifiable differences between certain transactions or events do not necessarily equate to a clear difference in substance that justify applying a new or revised accounting principle

EY resources

- *Financial reporting developments, Equity method investments and joint ventures* (SCORE No. BB02230)
- *Financial reporting developments, Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests* (SCORE No. BB02856)
- *Technical Line, A closer look at the new definition of a public business entity* (SCORE No. BB2708)

Equity method accounting and the definition of 'public business entity'

US GAAP defines a public business entity (PBE) broadly, saying a business is a PBE if it meets certain criteria including:

> "(a) it is required to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in the filing)."

As a result, equity method investees whose financial statements or summarized financial information are included in a registrant's filing under Regulation S-X, Rule 3-09, *Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons*, Regulation S-X, Rule 3-05, *Financial Statements of Businesses Acquired or to Be Acquired*, or Regulation S-X, Rule 4-08(g), *Summarized Financial Information*), are considered PBEs for the purposes of such financial statements or financial information. This would require those investees to use PBE effective dates for new accounting standards such as ASC 606.[10]

When equity method investees meet the definition of a PBE, Jonathan Wiggins, a staff member in OCA, said that the registrant's equity method accounting should be based on the investees' financial statements prepared using the PBE effective dates of new standards.

Mr. Wiggins said this wouldn't be the case for an equity method investee that doesn't otherwise meet the definition of a PBE such as when a registrant just uses the investee's financial information as a basis for recording equity method earnings or losses. Mr. Wiggins said that "amounts recognized by a registrant in applying the equity method of accounting would not be considered financial information included in a filing with the SEC under the FASB's definition of public business entity." Therefore, such equity method investees would not be required to use the effective dates for PBEs solely for purposes of the registrant's equity method accounting.

Equity method investees that trigger summarized information or separate financial statements will need to apply PBE adoption dates in the registrant's financial statements for purposes of equity method accounting.

How we see it

Rule 4-08(g) requires summarized financial information about equity method investees in the notes to the financial statements if the investees individually or *in the aggregate*, exceed 10% significance under any of the significant subsidiary tests in Rule 1-02(w) of Regulation S-X. For this reason, individually insignificant equity method investees may meet the definition of a PBE if their significance, when considered in the aggregate with the investor's other equity method investments, requires disclosure of summarized financial information to be included in the investor's financial statements (whether such information is presented individually or in the aggregate with other investees).

Joint ventures, strategic alliances and other collaborative-type arrangements

Mr. Wiggins discussed the accounting implications of joint ventures, strategic alliances and other collaborative-type arrangements. He said a company may need to consider several accounting topics to determine the appropriate accounting for these arrangements. In addition, the facts and circumstances of an arrangement can significantly affect the accounting for that arrangement. For example, Mr. Wiggins reminded companies that they should carefully consider whether their conclusions regarding decision-making authority are consistent with the substance of the underlying arrangements and the objective of the consolidation guidance.

Alternatively, when the activities of an arrangement are conducted outside of a legal entity or the entity is not consolidated, Mr. Wiggins encouraged registrants to carefully evaluate the facts and circumstances of the arrangement to identify the applicable accounting guidance. For example, he said a company will need to determine whether an arrangement meets the definition of a joint venture or collaborative arrangement or whether it is in the scope of ASC 606.

Income taxes

Accounting considerations

ASC 740 includes a presumption that all undistributed earnings of a subsidiary will be transferred to the parent entity, resulting in the parent entity accruing taxes on the undistributed earnings[11] unless the parent has sufficient evidence of specific plans such that the remittance to the parent company will be postponed indefinitely.[12]

Mr. Staniszewski said that OCA has questioned registrants when disclosures made outside of the audited financial statements appeared to contradict assumptions relied upon in asserting indefinite reinvestment, and in certain cases, has objected to a deferred tax liability not being recognized. Mr. Staniszewski suggested companies consider coordination among multiple business functions within a company's global organization (e.g., accounting, treasury, tax) when considering the accounting for undistributed earnings.

MD&A disclosure considerations

Ms. Shah expressed concerns about the quality of MD&A disclosures related to income taxes. She said that registrants' income tax disclosures in MD&A often aren't cohesive and don't tell a complete story about the company's tax positions and related trends and uncertainties.

Ms. Shah said that when reviewing the income tax disclosures in MD&A, the staff is primarily looking for robust MD&A disclosures related to:

- Reasons for historical changes in the effective tax rate
- Discussion about changes in reconciling items between the effective and statutory tax rates
- Insight into the extent to which past income tax rates are indicative of future tax rates
- Trends and uncertainties related to changes in unrecognized tax benefits
- Differences between trends in income tax expenses and cash taxes paid

Ms. Shah also said that companies could improve the quality of their MD&A disclosures related to income tax rate reconciliations and cash in foreign jurisdiction that is subject to permanent reinvestment assertions. Ms. Shah also expressed concerns about boilerplate disclosures in MD&A related to changes in valuation allowances on deferred tax assets, particularly when valuation allowances are released. She said companies should provide more specific disclosures about the possible sources of taxable income used to support the reversal of valuation allowances on deferred tax assets.

Discount rates used to measure the interest cost of defined benefit pension plans

Following up on a speech at last year's Conference on the discount rate used to measure the interest cost in defined pension plans, Ms. Uejio said that the SEC staff in OCA consulted on a different fact pattern this year proposing to use the spot rate approach when the yield curve methodology was not used to measure the pension benefit obligation (PBO) but a hypothetical bond matching methodology was used instead.

Recently, the staff objected to the use of the spot rate approach when the yield curve methodology was not used because the measurement of the PBO and the determination of interest cost are integrated concepts, she said. That is, the information used to measure the PBO was not proposed to be used to calculate interest cost. Ms. Uejio said companies should measure the PBO first and then attribute the change in the PBO to the various components of net pension cost, including interest expense. In computing the interest expense, a company should use the same information it used to measure the PBO.

Establishing a grant date for share-based payments

Mr. May discussed the need for careful consideration when determining under ASC 718[13] whether a grant date has been established for share-based payment awards that include key terms or conditions subject to discretion of the compensation committee or the board (e.g., clawback provisions). Mr. May said that when determining whether a mutual understanding has been reached and a grant date has been established, a registrant also should assess the past practices exercised by those with authority over compensation arrangements and how those practices may have evolved over time. As part of this evaluation, Mr. May said registrants should consider whether appropriate ICFR exists to monitor those practices and support the judgment made by the company.

EY resources

- *Financial reporting developments, Segment reporting (SCORE No. BB0698)*

Segment disclosures

Ms. Shah discussed themes in recent staff comments on segment reporting and said segment disclosures continued to be one of the top areas of staff comments in 2016.

Ms. Shah highlighted the following broad categories of recent comments on segments:

- *Identification of operating segments* — The SEC staff generally objects to a company's assertion that a component is not an operating segment because no shared operating costs are allocated to the component. Ms. Shah noted that if gross margins are available for a component, it may indicate that discrete financial information is available to classify a component as an operating segment.

- *Aggregation of operating segments* — Some registrants do not perform a robust analysis for qualitative similarities if their analysis of economic similarities supports the aggregation of operating segments. Ms. Shah emphasized the importance of performing an analysis of qualitative similarities because all the criteria for aggregation must be met. In particular, she said qualitative similarities should be considered in light of the scope and diversity of a company's products and services. Regarding the analysis of economic similarities, she noted that there is no bright line quantitative threshold in ASC 280, and registrants should use reasonable judgment, taking into account their understanding of the business and industry.

Ms. Shah also reminded registrants that they should evaluate all relevant data points when reaching their conclusions on operating segments including the CODM report, organization chart, compensation arrangements and budgeting process.

How we see it

In our latest SEC Comments and Trends publication, segment reporting was the fifth most frequent topic of staff comment during the 12 months ended 30 June 2016, up two spots from seventh in the prior year.

EY resources

- *To the Point, SEC staff updates guidance on non-GAAP financial measures* (SCORE No. 01108-161US)
- *Technical Line, Spotlight on non-GAAP financial measures* (SCORE No. 00785-161US)
- *Technical Line, A closer look at the SEC staff's scrutiny of non-GAAP financial measures* (SCORE No. 03290-161US)

In most cases, the staff is unlikely to object to non-GAAP measures that remove restructuring charges.

Non-GAAP financial measures

The SEC staff has stepped up its focus on non-GAAP measures over the past year. Mr. Higgins reiterated comments made at last year's Conference that the staff is focusing on non-GAAP financial measures because of the growing divergence between these measures and GAAP measures and the emphasis by third parties on non-GAAP measures.

Mark Kronforst, Chief Accountant in DCF, told the audience that the SEC staff is not trying to "eradicate" non-GAAP financial measures. He noted that companies' use of non-GAAP financial measures has improved over the course of the year, especially relating to prominence of their presentation, but that there is still some work to be done.

Mr. Kronforst expressed the staff's views on some specific non-GAAP measures and adjustments.

- *Stock compensation* — Mr. Kronforst indicated that the staff would not object to non-GAAP measures that include adjustments for stock compensation, but that there are best practices companies could follow to determine whether stock compensation adjustments are appropriate (e.g., considering whether stock compensation is integral to understanding the business).
- *Restructuring charges* — Despite recent staff comment letters asking companies whether adjustments for restructuring charges removed recurring cash operating expenses, the staff indicated it is unlikely to object to such adjustments in most cases. Any objections would likely be limited to fact patterns involving the constant monitoring and streamlining of costs to drive efficiency rather than individual "discrete restructuring plans," he said.
- *Business combinations* — Following a business combination, the staff will not object to non-GAAP adjustments that eliminate the effects of recording inventory or deferred revenue at fair value. However, the staff did not offer additional insight into other common non-GAAP adjustments related to business combinations such as acquisition costs or amortization of acquired intangibles.
- *Individually tailored accounting principles* — Mr. Kronforst said the staff has objected to a few types of non-GAAP measures that use individually tailored accounting principles.[14] These measures include those that accelerate revenue recognition, change the number of shares used in calculating earnings per share or alter consolidation principles by presenting financial statement measures using proportionate consolidation, for example. Mr. Kronforst clarified that, in limited situations, companies may make certain adjustments to revenue based on facts and circumstances (e.g., adjustments that reflect the expected effects of ASC 606) and that companies should discuss these adjustments in advance with the staff.
- *Prominence* — Companies' compliance with the rules on the relative prominence of non-GAAP financial measures has improved in recent earnings releases and filings. However, the staff is now issuing comments requesting that companies present the GAAP measure first in the required non-GAAP reconciliation (i.e., reconciling from GAAP to the non-GAAP measure) because presenting the non-GAAP measure first would give it undue prominence.

Mr. Kronforst said that until the staff performs additional outreach and research, it is unlikely to comment on measures with adjustments for certain aspects of pension accounting or unrealized gains or losses on derivatives. As it relates to non-GAAP measures and ASC 280 segment disclosures, companies cannot circumvent the non-GAAP rules by presenting multiple segment measures of profit in their financial statements nor should they present a segment measure of profit when there is only one reportable segment.

Members of a panel on non-GAAP measures also discussed whether non-GAAP measures presented in an earnings release or other communication would need to be included in the subsequent SEC filing (e.g., 10-K or 10-Q). While there is no legal requirement to do so, the consensus was that companies should consider whether the non-GAAP measures are integral to understanding the business through the eyes of management and therefore should be disclosed in MD&A.

Other non-GAAP considerations

Mr. Kronforst said the staff has given companies some flexibility to adjust their non-GAAP measures to conform to the updated interpretations over more than one interim period. This transition period was helpful for companies to give users time to adjust to using the revised non-GAAP measures.

The staff also mentioned that it will not consider changes made to implement the updated interpretations to be a deficiency in the company's prior DCP. However, companies should strengthen their DCP to help prevent future non-compliance. Representatives from the SEC's Division of Enforcement emphasized the importance of DCP and said that non-GAAP measures have become a significant area of focus for them.

The SEC staff has challenged whether PCAOB inspections findings are also indicative of deficiencies in management's assessment of ICFR.

Standard setters on non-GAAP

Standard setters within and outside the US are focusing on non-GAAP measures. The FASB and PCAOB are discussing with their advisory committees and stakeholders how and why investors use non-GAAP measures. In addition, Hans Hoogervorst, IASB Chairman, said that IASB members "share the SEC's concern that non-GAAP generally paints a rosier picture of a company's performance than GAAP … non-GAAP measures that consistently flatter a company's performance are probably not the best basis for sound business decisions." He said companies' audit and compensation committees need to challenge whether such measures are used appropriately.

ICFR, audit standards and independence matters

Internal control over financial reporting

The PCAOB held a number of outreach sessions in 2016 with various stakeholders to continue the dialogue that began in 2015 regarding concerns about ICFR assessments. PCAOB members and staff participated, along with auditors, audit committee members, financial statement preparers and observers from the SEC staff.

In a panel discussion on ICFR, PCAOB member Jay Hanson and Kevin Stout, Senior Associate Chief Accountant in OCA, characterized these discussions as constructive. They noted that while initiatives undertaken in 2015 hadn't yielded all the benefits that were expected due to their timing, progress appears to have been made in a number of areas. As a result, they emphasized the need for ongoing interaction between these parties to improve both the effectiveness and efficiency of ICFR assessments.

As they did at last year's Conference, members of the SEC staff stressed the importance of open and timely communication among management, the auditor and the audit committee regarding risk assessments, the extent of tests of controls and the level of evidence needed to support both management's assessment and the auditor's conclusions on ICFR.

Marc Panucci, who took over recently as Deputy Chief Accountant for Professional Practice in OCA, said that "timely and effective communication between these parties on ICFR remains of continued importance, not only for accurate assessments of ICFR, but also ultimately for more reliable financial reporting for the benefit of investors." Mr. Stout added that this dialogue is critical to bridging the differences that may exist between management's and the auditor's risk assessments. Mr. Stout also emphasized that this dialogue should occur timely and at an appropriate level of detail to have a meaningful effect on the development of an effective and efficient ICFR audit plan.

ICFR continues to be a significant source of PCAOB inspection findings. Mr. Stout encouraged management and audit committees to view those findings broadly and consider whether they indicate deficiencies in management's processes. Specifically, Mr. Stout asked registrants to consider whether PCAOB inspection findings may indicate that management is:

- Placing unwarranted reliance on controls that are not designed at a sufficient level of precision to address the risk(s) of material misstatement
- Not considering whether the effectiveness of a control depends on the effectiveness of other controls, and properly assessing the effectiveness of those controls
- Improperly concluding on the design and operating effectiveness of certain controls without sufficient evidence

Members of the SEC staff also reminded management, auditors and audit committees that they need to consider ICFR when implementing and adopting new accounting standards, including controls over the transitional disclosures required prior to adoption of new accounting standards. Mr. Panucci stressed that "qualified accounting resources and appropriate processes and controls will be of vital importance in connection with the adoption of the new accounting standards."

How we see it

We continue to support the efforts of the SEC and the PCAOB to encourage dialogue between financial statement preparers, auditors and audit committees to promote more efficient and effective audits of ICFR. We also encourage the PCAOB to continue its efforts with respect to improving its standard-setting process and other outreach efforts.

Implementation and monitoring of new audit standards

Jennifer Todling, a staff member in OCA, stressed the importance of having a wide range of constituents involved in monitoring the implementation of new audit standards. Ms. Todling noted that while auditors will have direct responsibility for implementation, "other stakeholders, including audit committees, management, investors and academics should consider how they can contribute to help maximize the intended benefits and minimize potential unintended consequences of new auditing standards."

Specifically, Ms. Todling emphasized the importance of frequent communication among stakeholders to promote the efficient implementation of new auditing standards and the early identification of challenges. Regulators, including the PCAOB, "should also consider whether they have provided adequate guidance to facilitate successful implementation" and remain engaged with and responsive to stakeholders during the post-implementation period.

Auditor independence matters

Mr. Panucci emphasized that compliance with the auditor independence rules continues to be a significant topic of consultations with OCA, particularly with regard to the adoption and implementation of new accounting standards. The SEC staff has seen an increase in questions about relationships and/or services not specifically prohibited by Rule 2-01(c) of Regulation S-X and that require consideration under the general standard of auditor independence.

Mr. Panucci said these rules are important to keep in mind not only when the audit committee pre-approves permissible non-audit services but also throughout the delivery of the service. As non-audit services are provided, "scope creep" into prohibited services would impair the auditor's independence.

Mr. Panucci emphasized that the growth of audit firms' consulting practices continues to be an important area to monitor as audit quality and independence are critical to investor's confidence in the audit. Mr. Panucci said the PCAOB's recently issued strategic plan identifies the firms' multidisciplinary structure as an emerging threat to auditor independence that the PCAOB will continue to monitor. He added, "A sustainable and viable audit profession is critically important for investors."

Accounting and SEC standard-setting update

FASB Invitation to Comment

Ms. Cosper gave an overview of the responses to the FASB's Invitation to Comment, *Agenda consultation*. The FASB received 45 comment letters, and the majority were from practitioners and preparers. The top priorities cited by the respondents included addressing the complexity of distinguishing liabilities from equity and concerns about the balance sheet classification of intangible assets. She said that users generally believe that reporting performance and cash flows should be a priority. One general concern respondents had was that, given the significant efforts required to implement new accounting standards, the FASB should allocate sufficient resources to practice issues and implementation support. Some respondents said the FASB should slow the pace of accounting change.

Disclosure effectiveness and SEC rulemaking

Regulation S-X and S-K concept releases

Mr. Higgins highlighted the SEC's rulemaking initiatives, particularly in the area of disclosure effectiveness. DCF made significant progress over the last year on disclosure effectiveness initiatives and SEC rulemaking required by the Fixing America's Surface Transportation (FAST) Act. Mr. Higgins noted the issuance of the recent report to Congress as required under the FAST Act with recommendations to modernize and simplify Regulation S-K. He observed that the report is distinct from the broader disclosure effectiveness initiative and does not provide a comprehensive list of changes under consideration to enhance disclosure effectiveness. Based on comment letters received in response to the SEC's Request for Comment, DCF is working on recommendations to the Commission on the rules in Regulation S-X about financial statements for entities other than the registrant.

DCF is also considering feedback on its Regulation S-K concept release. While some respondents favored additional environmental, social and governance (ESG) disclosure requirements, Mr. Higgins said there are diverse views on whether mandating ESG disclosures would be relevant for investors. A separate panel discussed efforts by the Sustainability Accounting Standards Board and other groups to develop standards for ESG disclosures.

Disclosure Update and Simplification Proposing Release (DUSTR)

The SEC staff views DUSTR as a "technical clean up" to remove outdated and redundant disclosure requirements, or refer to the FASB the current SEC disclosure requirements that overlap with US GAAP, without significantly altering the mix of information available to investors. The SEC staff said the level of support for the specific proposals in this release varied significantly. Investors generally asked for more rather than less disclosure, such as in the area of income taxes, while others supported removing substantially all the redundant and duplicative disclosure requirements identified in DUSTR.

Future rulemaking

Looking ahead, Mr. Higgins suggested that the proposed legislation in the Financial CHOICE Act, which has been passed by the House Financial Services Committee, could affect past and future SEC rulemaking. Among other things, the bill calls for repeal of certain disclosures mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, including those on conflict minerals, mine safety, resource extraction and the CEO pay ratio, in addition to other disclosures not yet adopted by the Commission. The CHOICE Act also would limit compensation clawbacks due to restatements to executives with responsibility for financial reporting, and it would expand exemptions under Section 404(b) of the Sarbanes-Oxley Act.

Interactions with the staff

OCA accounting consultation requests

Ms. Minke-Girard said OCA responded to approximately 125 accounting consultation requests over the past year, half of which came directly from registrants, while the rest came from the other SEC divisions and offices. She also said that approximately 30% of the accounting consultation requests involved smaller registrants and audit firms. She said the top three consultation topics were revenue recognition, business combinations and financial assets.

Division of Corporation Finance process matters

DCF staff provided practical advice about the SEC comment letter process. The staff characterized the comment letter process as a dialogue, observing that a registrant that receives a question from the staff should not necessarily presume that a change is warranted. The staff also recommended that registrants discuss materiality in their responses because the staff will not pursue further action on immaterial items. SEC staff members cautioned companies against analogizing to other registrants' fact patterns in published comment letters because the basis of resolution may not always be apparent from what is publicly available.

'Remember that a comment letter process is a dialogue and don't add disclosures just to end the review.'

– Cicely LaMothe, Associate Director in the Division of Corporation Finance

For transactional filings, the staff recommended that the registrants allow sufficient time for the staff to evaluate significant new information added to filings, which could influence the offering schedule and timing of the road show.

On interpretive and waiver letters submitted to DCF-OCA, the staff recommended that registrants seek the input and feedback of their auditors prior to submission to make the review more efficient. DCF staff is planning to revise their protocol to require the independent auditor be involved in requests to waive or modify financial statement requirements.

International matters

The IFRS footprint and outlook for IFRS

Mr. Hoogervorst thanked Chair White "for the constructive cooperation [between the SEC and the IASB]… and for the considerable time and effort she devoted to [the IASB's] cause." He also noted that the FASB and IASB have a very cordial relationship that will continue in the future.

Mr. Hoogervorst said that three quarters of the G20 countries will be using IFRS when Saudi Arabia adopts the standards in 2017. He added that the number of companies voluntarily using IFRS in Japan is rising and that there have been significant developments in India towards adopting IFRS.

Mr. Hoogervorst also discussed the outlook for the IASB's standard setting over the next 12 months. The IASB is in the process of finalizing its Conceptual Framework and will issue a new insurance contracts standard in the first half of 2017 that is expected to result in more consistent reporting across the globe. He said that with completion of this standard, the IASB will have filled most of the gaps in the IFRS suite of standards and that the IASB will focus in the next couple of years on improving the current standards. He said the IASB needs to improve the communication value of financial reporting by addressing disclosure effectiveness, performance reporting and changes in how users obtain and use financial information.

Finally, Mr. Hoogervorst noted that the US continues to have an interest in IFRS given its widespread and expanding use around the globe. While IFRS is not required in the US, he noted that US investors have more than $7 trillion dollars invested in companies that report under IFRS.

Foreign private issuers and cross-border reporting challenges

Mr. Olinger said that as of 31 December 2015, about 500 of the approximately 900 foreign private issuers (FPIs) registered with the SEC prepared their financial statements in accordance with IFRS as issued by the IASB, and about 400 FPIs prepared their financial statements in accordance with US GAAP. Very few FPIs prepare financial statements in accordance with home-country GAAP reconciled to US GAAP.

Mr. Olinger said that the staff's comments to companies reporting under IFRS are similar to those it issues to companies reporting under US GAAP. Many of these issues are complex, and the IFRS and US GAAP accounting standards that govern them are converged or largely converged. As a result, he said the staff's comments tend to be driven by the nature of the events or transactions at the company rather than differences in the accounting standards.

Mr. Olinger also shared insights about the staff organization and process when evaluating accounting issues. DCF-OCA's staff and OCA staff are generally organized by accounting topics and not by category of issuers (domestic vs FPI) or by GAAP (US GAAP vs IFRS). He emphasized that the staff is careful to adhere to the IFRS standards when applicable rather than applying a US GAAP bias.

SEC enforcement and PCAOB inspection matters

Remarks of SEC enforcement staff

Andrew Ceresney, Director of the SEC's Division of Enforcement, and Michael Maloney, Chief Accountant in the Division of Enforcement, discussed the SEC's enforcement actions over the past fiscal year. Mr. Ceresney said the SEC filed a record number of cases (868) and ordered over $4 billion of disgorgement and penalties in the fiscal year ended 30 September 2016. Mr. Ceresney said that these enforcement actions involved the full spectrum of the federal securities laws.

Mr. Ceresney said that the Commission continued to enhance its use of data analysis and other tools to identify potential cases of misconduct. In a separate panel discussion, Scott Bauguess, a Deputy Director and Deputy Chief Economist in the SEC's Division of Economic and Risk Analysis, said the SEC has enhanced its data analysis tools to more effectively gather and analyze unstructured data in SEC filings to identify anomalies that may indicate potential fraud or misconduct.

Mr. Maloney discussed enforcement actions related to financial reporting matters and observed that the number and nature of accounting and auditing enforcement cases did not significantly change from the last fiscal year. Mr. Maloney said that these cases were primarily related to allegations of recording unsupported revenues, inappropriate acceleration of revenue recognition, untimely rebate income and expense recognition, understatement of expenses and accrued liabilities, and asset valuation and impairment issues.

Mr. Maloney also said that the SEC has brought enforcement actions against auditors for independence violations involving close personal relationships with management, and for audit failures stemming from a lack of sufficient professional skepticism, overreliance on management representations, and failure to obtain adequate audit evidence.

Mr. Maloney highlighted one recent enforcement action in which fraudulent journal entries to reduce the effective tax rate were masked by complex and convoluted explanations by certain members of management to mislead the auditors. Mr. Maloney emphasized that auditors need to use professional care and seek help from experts as appropriate when dealing with complex accounting areas.

PCAOB inspections

Helen Munter, Director of Registration and Inspections at the PCAOB, said that she believes audit quality is improving as inspection findings continue to trend downward. Ms. Munter stated that audit firms are more engaged, and firms are focusing on timely root cause analyses and taking substantive remedial actions. However, Ms. Munter noted there are still opportunities for improvement in certain areas of recurring inspection findings, including management review controls and other aspects of ICFR, assessing and responding to risks of material misstatement, and auditing accounting estimates, including fair value measurements. Therefore, despite the extensive remedial actions taken by audit firms, "We are approaching a critical point where without elimination or significant reduction of the most troubling recurring findings, firms should not expect that they will be able to satisfy remediation requirements easily," Ms. Munter said.

The PCAOB staff also identified three positive trends during 2016 inspections:

- Auditors are doing a better job of understanding issuers' processes, transactions and controls.
- Auditors are doing a better job of coaching at both the team level and the individual level.
- Firms are doing a better job of monitoring audit team performance during the execution phase of the audit.

Ms. Munter addressed the PCAOB's inspection methodology, noting that it continues to evolve. In 2017, she anticipates the formation of a team of inspectors dedicated to inspecting financial services audits across multiple firms to give the PCAOB the ability to consistently articulate concerns "in an effort to drive rapid remediation efforts in this very challenging area." Ms. Munter also said the PCAOB plans to issue a report summarizing the PCAOB's inspection findings associated with the implementation of AS 2410, *Related Parties*.

Ms. Munter said the PCAOB's 2017 inspections will likely focus on:

- Areas of recurring deficiencies, including ICFR, assessing and responding to risks of material misstatement and auditing accounting estimates, including fair value measurements
- Going concern evaluations
- Audit areas affected by economic risks and higher financial reporting risks, such as those affected by fluctuations in oil and gas prices
- Implementation of the PCAOB's new auditing standard on auditor transparency

- Implementation efforts for new accounting standards, including how firms are managing change and preparing audit teams to evaluate a company's transition, how they are monitoring and maintaining independence in connection with the transition and how they are reporting any concerns about an issuer's readiness to the audit committee

As part of the inspection process, the PCAOB will also inform their standard setting agenda through:

- Gathering information about the auditor's consideration, if any, of a company's use of non-GAAP measures, and what auditors do if a company is more aggressive in its use of these measures
- Gathering information about firms' use of technology in the performance of audits, including data analytics

Endnotes:

[1] EY Center for Board Matters, *Audit Committee Reporting to Shareholders in 2016*

[2] Rule 2-01(b) of Regulation S-X.

[3] 401.09.b Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported.

[4] SEC SAB Topic 6.L, Accounting for Loan Losses.

[5] For public business entities (PBEs), ASU 2016-1, *Financial Instruments — Overall (Subtopic 825-10),* is effective for fiscal years beginning after 15 December 2017, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Non-PBEs may adopt the standard as of the effective date for PBEs. Early adoption is permitted for certain provisions, including the provision requiring the presentation of the fair value change from instrument-specific credit risk in Other Comprehensive Income (OCI) for financial liabilities measured using the Fair Value Option(FVO) in ASC 825.

[6] ASC 815-15-25-1.

[7] ASC 815-15-25-4 through 5.

[8] Financial Reporting Manual (Question 11310.1).

[9] ASC 250, *Accounting Changes and Error Corrections*.

[10] ASC 606, *Revenue from Contracts with Customers*.

[11] ASC 740-30-25-3.

[12] ASC 740-30-25-17.

[13] ASC 718-10-30-3.

[14] Compliance and Disclosure Interpretations on Non-GAAP Financial Measures - Question 100.04

Appendix — Conference speeches

	Speech and link to source
SEC Chief Accountant, Wesley Bricker	▸ Speech by SEC Chief Accountant: Working Together to Advance High Quality Information in the Capital Markets
SEC Deputy Chief Accountant, Julie Erhardt	▸ Speech by SEC Deputy Chief Accountant: Remarks at the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Deputy Chief Accountant, Marc Panucci	▸ Speech by SEC Deputy Chief Accountant: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Assistant Deputy Chief Accountant, Jenifer Minke-Girard	▸ Speech by SEC Assistant Deputy Chief Accountant: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Associate Chief Accountant, Jonathan Wiggins	▸ Speech by SEC Associate Chief Accountant: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Sylvia Alicea	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Sean May	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Brian Staniszewski	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Jennifer Todling	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Ruth Uejio	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
PCAOB Chair, James Doty	▸ Speech by PCAOB Chair: PCAOB's Role in Enhancing Public Trust and Integrity in Audits
PCAOB Director of Enforcement, Claudius Modesti	▸ Speech by PCAOB Director of Enforcement: Protecting Investors through Enforcement
FASB Chairman, Russell Golden	▸ Speech by FASB Chairman: Remarks at the 2016 AICPA Conference on Current SEC & PCAOB Developments
IASB Chairman, Hans Hoogervorst	▸ Speech by IASB Chairman: Safety in numbers
CAQ Executive Director, Cindy Fornelli	▸ Speech by CAQ Executive Director: Profession Proud

No. 2016-51
8 November 2016

To the Point

FASB TRG reaches general agreement on four more revenue recognition issues

Members of the FASB TRG reached general agreement on all four issues they discussed at their last scheduled meeting.

What you need to know

- Members of the FASB TRG reached general agreement on implementation issues involving capitalization and amortization of incremental costs of obtaining a contract, payments to customers, over time revenue recognition and sales- or usage-based royalties that contain minimum guarantees.
- While this is the last scheduled FASB TRG meeting, FASB Vice Chairman James Kroeker said entities can continue to send the FASB questions about implementation, and more TRG meetings could be scheduled if enough broad questions are received.

Overview

The Financial Accounting Standards Board (FASB) Transition Resource Group for Revenue Recognition (TRG) reached general agreement on four implementation issues stakeholders have raised about the new revenue recognition standards[1] the FASB and the International Accounting Standards Board developed jointly. The issues involve capitalization and amortization of incremental costs of obtaining a contract, payments to customers, over time revenue recognition and sales- or usage-based royalties that contain minimum guarantees.

While TRG members' views are non-authoritative, entities should consider them as they implement the new standards. Wesley Bricker, Interim Chief Accountant of the Securities and Exchange Commission (SEC), has encouraged entities to consult with his office if they are considering applying the guidance in a manner that is different from what TRG members generally agreed on.[2]

Building a better working world

While this is the last scheduled FASB TRG meeting, FASB Vice Chairman James Kroeker said entities can continue to send the FASB questions about implementation, and more meetings could be scheduled in 2017 if enough broad questions are received. The FASB staff noted it has received questions from entities about the standard's disclosure requirements. The FASB staff indicated that entities should keep the overall disclosure objective in mind as they plan their disclosures. That is, while entities should use judgment when determining how to provide certain disclosures, the disclosures should enable users of the financial statements to understand the nature, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Mr. Kroeker said the FASB also plans to host a workshop on the accounting for up-front efforts related to preproduction activities, such as tooling in the automotive industry and non-recurring engineering costs in the aerospace and defense industry.

Incremental costs of obtaining a contract

Under Accounting Standards Codification (ASC) 340-40, *Other Assets and Deferred Costs — Contracts With Customers*, incremental costs of obtaining a contract (e.g., sales commissions) will be recognized as an asset if the entity expects to recover them.

An entity will need to apply judgment to determine the amortization period for an asset recognized for the incremental costs of obtaining a contract.

FASB TRG members generally agreed that commissions paid to all employees, regardless of how directly involved they were in obtaining a contract, would be considered incremental costs if they wouldn't have been incurred if the contract had not been obtained. This would include commissions based on achieving a certain threshold of new contracts. However, if obtaining the contract was one of several factors used to determine a discretionary bonus payment to an employee, the bonus would not be considered an incremental cost of obtaining a contract.

ASC 340-40 requires that any capitalized incremental costs be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. In doing this, an entity must determine whether the capitalized costs relate only to goods or services that will be transferred under the initial contract or whether the costs also relate to goods or services that will be transferred under a specific anticipated contract. For example, if an entity pays a commission based only on the initial contract and doesn't expect a renewal (e.g., based on its past experience or other relevant information), amortizing the asset over the initial term would be appropriate.

However, if the entity's past experience indicates that a renewal is likely, the amortization period would be longer than the initial term if the renewal commission is not "commensurate" with the initial commission. FASB TRG members generally agreed that the commissions would have to be reasonably proportional to the contract values (e.g., 5% of both the initial and renewal contract values) to be considered commensurate. FASB TRG members also generally agreed that it would not be reasonable for an entity to conclude, for example, that a 6% commission on an initial contract and a 2% commission on a renewal were commensurate, based on an analysis of the level of effort required to obtain the contracts.

FASB TRG members generally agreed that an entity will need to evaluate its facts and circumstances to determine an appropriate amortization period if it determines that the period should extend beyond the initial contract term because the commission on the renewal contract is not commensurate with the commission on the initial contract. While an entity might reasonably conclude that its average customer term is the best estimate of the amortization period that is consistent with the transfer of the goods or services to which the asset relates (e.g., if the good or service does not change over time such as a health club membership), FASB TRG members generally agreed that this approach is not required and that entities should not default to it. FASB TRG members said entities would use similar judgment to what they do today when estimating the amortization period for intangible assets (e.g., a customer relationship intangible acquired in a business combination) and could consider factors such as customer "stickiness" and how quickly their products and services change.

How we see it

Entities that expense commissions under legacy GAAP will have to record an asset for payments they expect to recover, and entities that capitalize commissions under legacy GAAP will have to capitalize all incremental costs of obtaining a contract, regardless of whether the employee is directly involved in obtaining the contract.

In addition, an entity that pays smaller commissions to employees for annual renewals than for initial one-year contracts is likely to amortize the initial contract's capitalized costs over a period of longer than one year. As a result, the entity would not qualify for the practical expedient that allows expensing of costs to obtain a contract if a capitalized asset otherwise would have been amortized over a period of one year or less.

Payments to customers

ASC 606 requires entities to record payments to customers in cash or in the form of coupons, credits or vouchers as reductions of revenue, unless the payment is in exchange for a distinct good or service. While the guidance clearly applies to payments to customers under current contracts, stakeholders have raised questions about how to account for up-front payments to potential customers and payments that relate to both current and anticipated contracts.

FASB TRG members discussed two approaches. Under View A, an entity would recognize an asset for the up-front payment and reduce revenue as the related goods or services (or as the expected related goods or services) are transferred to the customer. As a result, the payment could be recognized in the income statement over a longer period than the contract term. Entities would determine the amortization period based on facts and circumstances and would assess the asset for recoverability using the principles in other asset impairment models in US GAAP. Under View B, entities would reduce revenue from the current contract by the amount of the payment. If there is no current contract, entities would recognize a payment immediately in the income statement.

FASB TRG members generally agreed that the determination is not an accounting policy election and that entities will need to use the approach that best reflects the substance and economics of the payment to the customer. Entities would evaluate the nature of the payment, the rights and obligations under the contract and whether the payment meets the definition of an asset. Some FASB TRG members noted that this evaluation was consistent with today's accounting for payments to customers and therefore similar conclusions may be reached under ASC 606. FASB TRG members also said an entity's decision on which approach is appropriate may be a significant judgment in the determination of the transaction price that would require disclosure under ASC 606.

Over time revenue recognition

FASB TRG members generally agreed that an entity that recognizes revenue at a point in time under legacy guidance will need to analyze each of its contracts to determine whether it will be required to recognize revenue over time under the new standard. An example would be a contract manufacturer that produces goods designed to a customer's unique specifications and can reasonably conclude that the goods do not have an alternative use. If the manufacturer also has an enforceable right to payment for performance completed to date, it would meet the standard's third criterion to recognize revenue over time, even though it might recognize revenue at a point in time under legacy GAAP (e.g., based on a units-produced or units-delivered method).

FASB TRG members generally agreed that when an entity evaluates whether its performance creates an asset with no alternative use, it should consider whether it could sell the *completed* asset to another customer without incurring a significant economic loss (i.e., whether it could sell the raw materials or work-in-process to another customer is not relevant).

FASB TRG members also discussed some questions that have been raised in practice related to the determination of whether an entity has an enforceable right to payment for performance completed to date. FASB TRG members generally agreed that entities will need to evaluate the contractual provisions and determine whether the right to payment compensates the entity for performance completed to date. For example, the FASB TRG noted an entity may not always have an enforceable right to payment at contract inception, such as when an entity is producing standard goods that may be customized for a customer towards the end of the production process. FASB TRG members generally agreed that an entity should consider whether it has an enforceable right to payment related to its performance completed to date. If the entity's performance obligation is to customize its standard goods for a customer, FASB TRG members generally agreed that an entity would evaluate whether it has an enforceable right to payment at the point that the entity begins to satisfy the performance obligation to customize the goods for the customer.

Minimum guarantees of sales- or usage-based royalties

FASB TRG members generally agreed that a minimum guaranteed amount of sales- or usage-based royalties in a license of functional intellectual property (IP) should be recognized as revenue at the point in time the entity transfers control of the license to the customer, like other revenue for this type of IP license. Any royalties above the fixed minimum would be recognized in accordance with the royalty recognition constraint (i.e., at the later of when the sale or usage occurs or when the entity satisfies the performance obligation to which some or all of the royalty has been allocated).

However, FASB TRG members generally agreed that various recognition approaches could be acceptable for minimum guarantees in licenses of symbolic IP, which require revenue to be recognized over time. The TRG agenda paper describes two approaches. Under one, an entity would estimate the total consideration (i.e., the fixed minimum and the variable consideration from future royalties) and apply an appropriate measure of progress to recognize revenue as the entity satisfies the performance obligation, subject to the royalty recognition constraint. Alternatively, an entity could apply a measure of progress to the fixed consideration and begin recognizing the variable component when the fixed amount is exceeded on a cumulative basis. An entity should disclose the accounting policy it selects because this would likely affect the amount and timing of revenue recognized.

Endnotes:

[1] ASC 606, *Revenue from Contracts with Customers* (created by Accounting Standards Update 2014-09), and IFRS 15 *Revenue from Contracts with Customers*.

[2] Speech by Wesley R. Bricker, 5 May 2016. Refer to SEC website at https://www.sec.gov/news/speech/speech-bricker-05-05-16.html.

No. 2016-56
22 December 2016

To the Point

FASB — final guidance

FASB issues technical corrections and improvements to the new revenue standard

The amendments do not change any of the principles in the new revenue standard.

What you need to know

- The FASB issued final guidance that allows entities not to make quantitative disclosures about remaining performance obligations in certain cases and requires entities that use any of the new or previously existing optional exemptions to expand their qualitative disclosures. It also makes 12 other technical corrections and improvements to the new revenue standard.
- The amendments address questions that stakeholders have raised but don't change any of the principles in the new revenue guidance. No further changes to the new standard are currently expected before the effective date.
- The amendments have the same effective date and transition requirements as the revenue standard.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standards Update (ASU)[1] that allows entities not to make quantitative disclosures about remaining performance obligations in certain cases and requires entities that use any of the new or previously existing optional exemptions to expand their qualitative disclosures. It also makes 12 additional technical corrections and improvements to the new revenue standard.[2]

The FASB is still evaluating the accounting for preproduction costs in long-term supply arrangements, which was originally part of the technical corrections and improvements project on the new revenue standard. The FASB has not said whether further changes to the accounting for preproduction costs are forthcoming.

Building a better working world

Earlier in 2016, the Board amended the new revenue guidance on a number of topics, including licenses of intellectual property, identifying performance obligations and determining whether an entity is a principal or an agent.

Key considerations

Optional exemptions related to disclosures of remaining performance obligations

The ASU provides new optional exemptions related to the requirement for entities to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period.

Under the new guidance, entities can elect not to disclose variable consideration allocated to performance obligations related to either: (1) sales- or usage-based royalties on licenses of intellectual property or (2) variable consideration allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation when certain criteria are met. This election is intended to eliminate the need for entities to estimate variable consideration solely for disclosure purposes if they do not need to do so to recognize revenue.

The FASB also limited the guidance that allows an entity not to make the disclosure for revenue recognized in accordance with the "right to invoice" practical expedient in Accounting Standards Codification (ASC or Codification) 606-10-55-18 to variable consideration. That is, companies will have to disclose fixed consideration recognized under the right to invoice practical expedient. The Board made this change because the fixed consideration is known and does not require entities to make an estimate only for disclosure purposes.

Disclosure requirement when using optional exemptions

The ASU also added a disclosure requirement for entities that elect to use any of the standard's exemptions allowing them not to disclose the aggregate transaction price allocated to the remaining performance obligations. Entities will have to disclose which optional exemptions they are applying, the nature of the performance obligations and the remaining duration of the contract. They also will have to describe the variable consideration excluded from the quantitative disclosure.

Amendments to ASC 340

The ASU clarifies (1) the amounts to be included in the consideration an entity expects to receive when testing capitalized contract costs for impairment and (2) the interaction of impairment guidance in ASC 340-40[3] with other impairment guidance elsewhere in the Codification.

Due to concerns raised by stakeholders, the FASB didn't move forward with its proposal to supersede the guidance on accounting for preproduction costs in long-term supply arrangements. The Board directed the staff to perform additional research and outreach on that proposal and said it didn't want to delay the other amendments.

Scope clarifications

The ASU deletes the term "insurance" from the scope section in ASC 606 to clarify that all contracts (not just insurance contracts) within the scope of ASC 944[4] are excluded from ASC 606. The scope exception does not apply to contracts of insurance entities that are outside the scope of ASC 944. The ASU also clarifies that contracts entirely in the scope of ASC 944 don't have to be separated into components. Promises in a contract in the scope of ASC 944 that are provided to help fulfill that contract, such as insurance risk mitigation or cost containment activities, are accounted for under ASC 944. This is similar to how insurance entities currently determine whether elements of contracts are within the scope of ASC 944.

The ASU also adds a scope exception to ASC 924-815[5] to clarify that fixed-odds wagering contracts for casino entities are within the scope of ASC 606 and do not need to be accounted for under the derivative guidance.

The ASU also addresses the consequential amendments in ASC 310-10[6] and ASC 942-825[7] to clarify that ASC 606 does not apply to fees for guarantees (other than product or service warranties) that are in the scope of ASC 460. Entities will account for these guarantees in accordance with ASC 460 or ASC 815.[8]

Updates to examples

Eliminate a reference to contract liability

The ASU eliminates the reference to a contract liability in the journal entry in Example 40 in the new standard, which illustrates the recognition of a receivable and a refund liability. The Board stated in the ASU's Background Information and Basis for Conclusions that an entity would determine whether a refund liability should be characterized as a contract liability based on the arrangement's facts and circumstances.

Clarify analysis in contract liability and receivable example

The ASU provides a better link between the analysis in Case B in Example 38 in the new standard and the receivables presentation guidance in ASC 606. The amendments clarify that an entity should recognize a receivable on the balance sheet when it has an unconditional right to consideration. Stakeholders expressed concerns that the example could be interpreted to mean that an entity cannot record a receivable before its due date.

The amendments will affect various industries.

The FASB said in the Basis for Conclusions that this clarification to the example about when to record a receivable generally should not result in a significant change in practice. However, the Board noted that there is currently some diversity in how entities determine when to record a receivable that may not be eliminated by the new guidance in ASC 606.

Amend contract modification example

In response to questions about Example 7 in the standard, the ASU changes the example to better align it with the principles in ASC 606. However, the conclusion in the example remains the same.

Other clarifications

The ASU also (1) amends the onerous contract test in ASC 605-35[9] to clarify that it is performed at the contract level (but an entity could perform it at the performance obligation level as an accounting policy election), (2) aligns the accounting for offering costs by advisers for both public and private funds under ASC 946,[10] (3) reinstates today's advertising cost accrual guidance on when to recognize liabilities for advertising costs and (4) clarifies that the disclosure of revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods applies to all performance obligations and is not limited to performance obligations with contract balances.

Effective date and transition

The amendments have the same effective date and transition requirements as the new revenue standard.

Endnotes:

[1] ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*.
[2] ASU 2014-09, *Revenue from Contracts with Customers,* created ASC 606 and ASC 340-40.
[3] ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*.
[4] ASC 944, *Financial Services — Insurance.*
[5] ASC 924-815, *Entertainment — Casinos — Derivatives and Hedging*.
[6] ASC 310-10, *Receivables — Overall.*
[7] ASC 942-825, *Financial Services — Depository and Lending — Financial Instruments*.
[8] ASC 815, *Derivatives and Hedging*.
[9] ASC 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*.
[10] ASC 946, *Financial Services — Investment Companies*.

REIT Wise® 2017

NAREIT's Law, Accounting & Finance Conference

March 24, 2017

Deep Dive #2: Implementing the New Revenue Recognition Standard

Faculty

- Moderator
  - Ermelinda Berberi, SVP-CAO, Paramount Group, Inc.
- Panelist
  - Melanie Meretsky, Director-Financial Reporting, Taubman Centers, Inc.
  - Joseph Ottinger, VP-Financial Reporting, Host Hotels & Resorts, Inc.
  - Jade Shopp, Partner, Deloitte Advisory Financial Services Industry

Agenda

- Overview of the new revenue standard
- Setting the stage – status of implementation
- Scoping significant contracts
- Accounting for sales of real estate
- Transition
- Impact on internal controls over financial reporting (ICFR)
- Next steps

Overview of the new revenue standard

Jade Shopp, Partner, Deloitte Advisory Financial Services Industry

Overview of the new revenue standard

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled

Step 1

Identify the contract with a customer

Step 2

Identify the performance obligations in the contract

Step 3

Determine the transaction price

Step 4

Allocate the transaction price to performance obligations ("PO")

Step 5

Recognize revenue when (or as) the entity satisfies a performance obligation

This revenue recognition model is based on a **transfer of control** approach, which differs from the **risks and rewards** approach applied under current US GAAP.

Scope of the new revenue standard

- Applies to an entity's contracts with customers
- Does not apply to:
  - Lease contracts (ASC 840, ASC 842)
  - Contracts within the scope of the insurance guidance in ASC 944
  - Certain financial instruments and other contractual rights or obligations
  - Guarantees (other than product or service warranties)
  - Nonmonetary exchanges whose purpose is to facilitate a sale to another party
- ***Some key aspects apply to transfer (sale) of nonfinancial assets (e.g., real estate) that do not meet the definition of a business.***

Glossary terms

Contract: An agreement between two or more parties that creates enforceable rights and obligations

Customer: A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration

Effective date & transition options

- **Effective date (public entities)**
  - Annual reporting periods beginning after December 15, 2017, including interim reporting periods therein; early application permitted
- **Transition options**
  - Full Retrospective – restate prior comparative periods
  - Modified Retrospective – apply to contracts not completed as of effective date

cumulative catch-up

January 1, 2018 Initial Application Year	2018 Current Year	2017 Prior Year 1	2016 Prior Year 2
New contracts	New ASU		
Existing contracts	New ASU + cumulative catch up	Legacy GAAP	Legacy GAAP
Completed contracts		Legacy GAAP	Legacy GAAP

Transition options

The following provides some key observations and potential challenges for each transition approach:

	Full retrospective	Modified retrospective
Dual reporting requirements	• Prior two comparative years (potentially three) required to be restated.	• Dual recordkeeping required in the year of adoption.
Comparability	• Full comparability as prior periods are restated. • Cumulative catch-up adjustment recorded on January 1, 2016.	• No comparability between current year and prior periods on primary financial statements. • Year of adoption comparability provided in footnote disclosures. • Cumulative catch-up adjustment will be on January 1, 2018.
System considerations	• The full retrospective method will require information to be prepared and validated before January 2018. Procedural "trial runs" will provide opportunity to fix potential unforeseen or unplanned challenges.	• More time to develop a one-time transition plan with more runway to fix data and system challenges ahead of "go-live" in January 2018.

Disclosure requirements – public entities

Background

The new revenue standard requires significant additional qualitative and quantitative disclosures for public entities. A public entity is defined in the new revenue standard as (1) a public business entity as defined in ASU 2013-12, (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements to the SEC. This information is provided for illustrative purposes only.

Required annual disclosures	Quantitative	Qualitative	Required on an interim basis?	Key decisions and considerations	ASC
1. Disaggregation of revenue	✓	✓	✓	• Determination of disaggregation categories • Choice between quantitative or qualitative reconciliation to segment revenue	606-10-50-5 through 50-7 & 606-10-55-89 through 55-91
2. Contract asset/liability balances	✓	✓	✓	• Consider adjusting more significant estimates	606-10-50-8 through 50-11
3. Nature of performance obligations		✓		• Description of key components of identified Pos	606-10-50-12
4. Amount and recognition timing of transaction price allocated to the remaining performance obligation	✓	✓	✓	• Preferred breakdown of remaining POs • Quantitative or qualitative presentation	606-10-50-13
5. Significant judgments used in determining the transaction price and satisfying performance obligations		✓		• Determination of whether there should be a specific list of judgments to reference when preparing the disclosure or whether the disclosure should be open-ended	606-10-50-18 through 50-19 & 606-10-50-20
6. Assets recognized from the costs to obtain or fulfill a contract	✓	✓		• Capability to identify costs that qualify for capitalization and to determine appropriate amortization period	340-40-50-1 through 50-4
7. Election of practical expedients		✓		• Capability to capture the use of practical expedients and apply practical expedients consistently	606-10-50-22 & 340-40-50-5

Disclosure requirements – non-public entities

Background
The new revenue standard requires significant additional qualitative and quantitative disclosures for non-public entities. The purpose of the expanded disclosure requirements is to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

Topic	Description	Freq	Quantitative	Qualitative	ASC
1. Disaggregation of revenue	Revenues from contracts with customers should be disaggregated based on timing of transfer of goods or services (point in time or over time) and qualitative information about how economic factors affect cash flows.	Annually	✓	✓	606-10-50-5 through 50-7 & 606-10-55-89 through 55-91
2. Contract balances	Opening and closing balances of contract assets, contract liabilities, as well as receivables related to contracts	Annually	✓		606-10-50-8 through 50-11
3. Performance obligations (POs)	When performance obligations are typically satisfied, significant payment terms, nature of goods or services promised, return and warranty obligations.	Annually		✓	606-10-50-12
4. Significant judgments used in determining the timing of satisfaction of performance obligations	Methods used to recognize revenue.	Annually		✓	606-10-50-18 through 50-19 & 606-10-50-21
5. Significant judgments used in determining the transaction price and the amounts allocated to performance obligations	Significant judgments (methods, inputs, and assumptions used) to assess whether estimate of variable consideration should be constrained.	Annually		✓	606-10-50-20 through 50-21

** Certain nonpublic exemptions exist*

Potential impacts of the revenue standard

Potential effects on real estate

Elimination of bright-line tests

- Prescriptive guidance provided by ASC 360-20 (Sales of Real Estate) and ASC 605 (Construction) will be removed:
  - Buyer’s financial commitment
  - Collectibility of transaction price
  - Continuing involvement by seller
  - Sales to limited partnerships/joint ventures
  - Guarantee buyer return
  - Partial sales
  - Condominium sales

- Collectibility threshold
  Must be **probable** (not necessarily **reasonably assured**) that the entity will ultimately collect the consideration it is entitled to receive

- Will likely result in **more transactions qualifying as sales of real estate** with **gains being accelerated**

Leases project

What about Common Area Maintenance ("CAM")?

The lease standard requires separate accounting for lease and non-lease (services) components of a contract

- Payments by tenant to landlord for taxes and insurance are generally considered part of the lease revenue
- Payments by tenant to landlord for common area maintenance are not part of the lease presented and disclosed in accordance with other topics

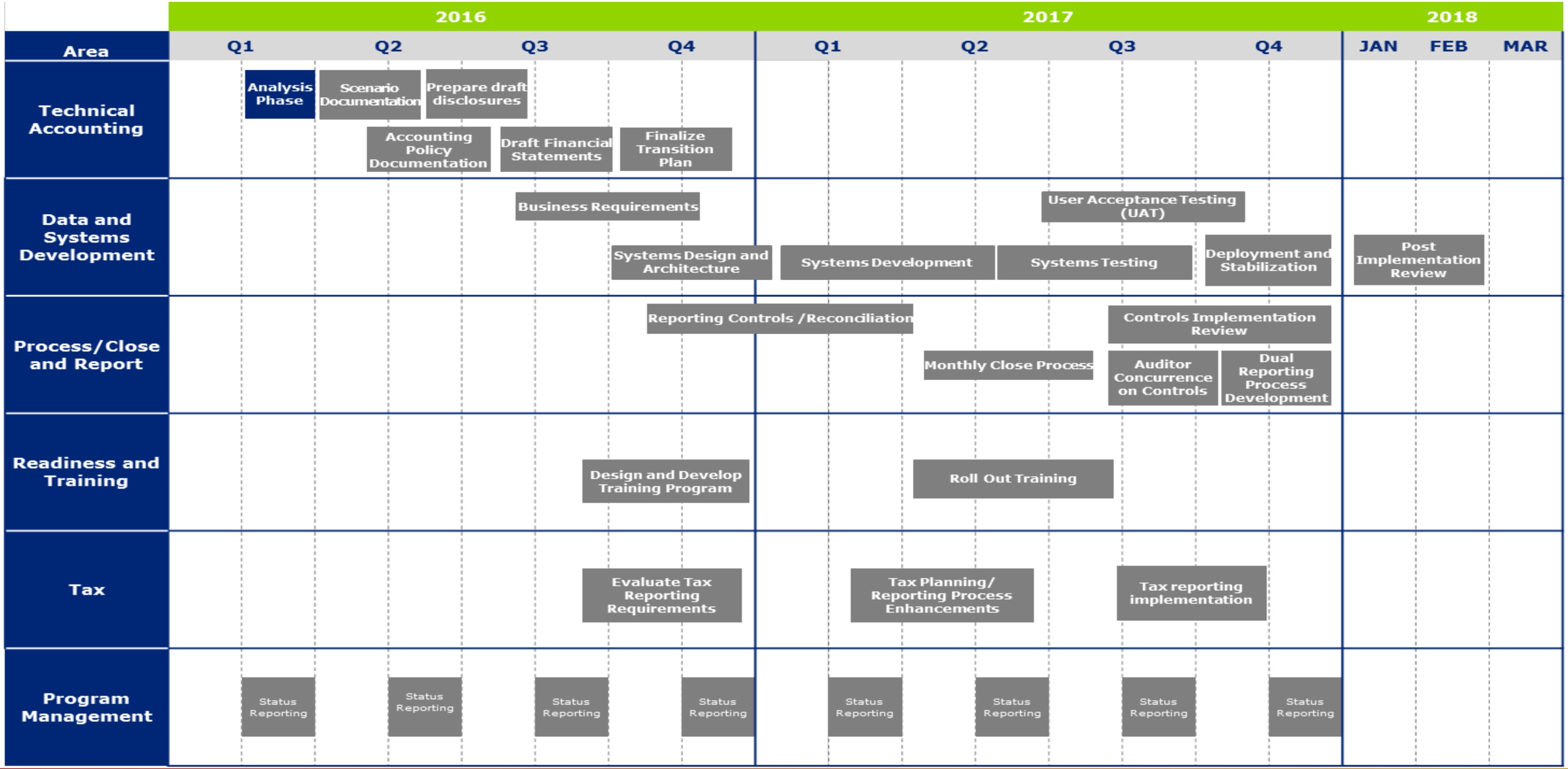
But

BC153: "…it similarly would be **reasonable** for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component **results in the same accounting** as treating those two elements as separate components). The…lessor may need to separately consider **presentation and disclosure** in accordance with other Topics."

Common components of an implementation

Illustrative revenue recognition roadmap

The following presents the types of activities that are expected to be required in the implementation of the standard:



Phase 1: Assessment illustrative timeline

Below is an illustrative timeline for the proposed assessment activities and related deliverables:

	Activities	Week 1–8
Program Management & Setup	Establish and perform PMO tasks including status updates	*Weekly status reports*
	Project kick-off meetings with identified stakeholders	*Kick-off materials*
Scoping	Hold workshops with stakeholders to identify significant revenue streams and contracts	*Impact assessment summary*
	Develop central repository for scoped in contracts	*Central repository*
	Hold revenue recognition training	*Training materials*
Contract Analysis	Review and assess contract arrangements against ASC 606	***Contract review summaries***
	Summarize contract reviews	***Summary of key contract terms***
Accounting and Operational Impact Analysis	Hold additional workshops and interviews based on contract reviews	***Contract review documentation***
	Document analysis of potential accounting differences, considerations, and recommendations	***Accounting position summaries***
	Conduct workshops to understand potential impacts on process, data and systems	***Process and data documentation***
	Document high-level observations of potential impacts	***Operational impact analysis***
Executive Summary & Roadmap	Prepare executive summary and conduct closing meeting	***Revenue recognition executive summary & illustrative roadmap***

◆ Milestones/ Work product delivery

▲ Status meetings (steering committee—weekly; executive committee—monthly)

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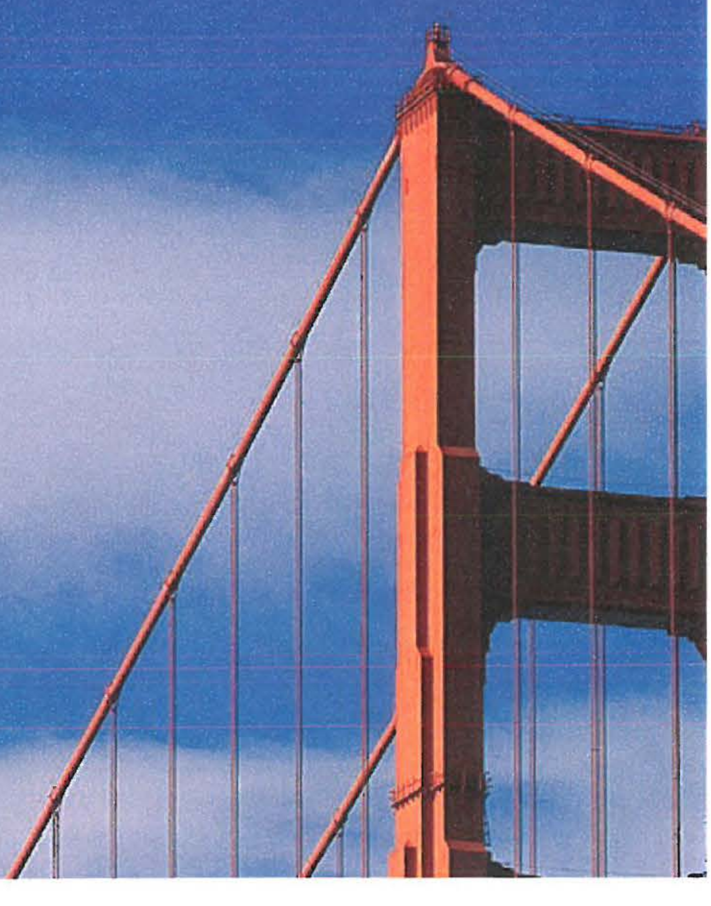
KPMG

Revenue: Real estate

Questions and Answers



August 2016

US GAAP

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Contents

All change for real estate

While it once seemed like a long way off, the 2018 effective date of the 2014 revenue recognition standard is fast approaching. The standard replaces most of the current US GAAP guidance on profit recognition for real estate sales.

The new standard requires real estate companies to determine its effect on their operations and accounting. As companies delve into the details, many are finding that the standard will affect them in some way. Those effects will vary widely depending on the nature of their businesses and their interactions with their customers and buyers.

In May 2016, we published the second edition of Revenue Issues In-Depth, which illustrates how the new standard applies to common transactions, provides examples about common scenarios, explains our emerging thinking on key interpretative issues, and compares the new requirements to current US GAAP.

This publication, now in its second edition, provides supplemental technical guidance on key issues when applying the new revenue model to sales of real estate, and focuses on the implications for US GAAP reporting entities. We address some of the common questions about the new standard's effects on sales of real estate, and we hope it will advance the dialogue on these and other issues.

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About this publication

Purpose

The purpose of this publication is to assist you in understanding the requirements of FASB ASC Topic 606 *Revenue from Contracts with Customers* and Subtopic 610-20 *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, as they apply to real estate transactions.

This publication is intended for use by preparers and other interested parties with a working knowledge of the existing real estate sales guidance and an understanding of the new revenue recognition model.

Organization of the text

The publication is in a Q&A format, and is organized into chapters that largely reflect the steps in the revenue model. Our commentary is referenced to the FASB ASC (or Codification), when excerpts are not included, where applicable. For example, 606-10-25-1 is paragraph 25-1 of ASC Subtopic 606-10.

Terminology

Unless otherwise indicated explicitly or by comparison, we use the terms 'customer' and 'buyer' interchangeably to refer to the purchaser in a transaction involving the sale of real estate. This is because the guidance in this publication addresses both the requirements of Topic 606 on revenue recognition from sales to customers, and the requirements of Subtopic 610-20 on recognition of gains and losses from the derecognition of nonfinancial assets in transactions with parties other than customers.

A Scope

A10. How do you determine whether real estate sales, including sales of financial assets that are in-substance real estate, fall within the scope of Topic 606 or Subtopic 610-20?

Determining which guidance applies depends on whether the buyer is a customer. If so, the seller accounts for the sale under Topic 606 and recognizes revenue and cost of sales. The Master Glossary defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." [Master Glossary, 360-10-40-3A]

A real estate developer predominantly in the business of selling retail land or residential units would be an example of an entity that likely is selling real estate as an output of its ordinary activities.

In contrast, a real estate investment trust (REIT) that primarily leases real estate generally would not sell real estate as an output of its ordinary activities. While some REITs often sell properties as part of their overall investment strategy, they identify the output of their normal activities as the service they provide to their tenants. This conclusion is consistent with how a REIT's operations are characterized for US federal income tax purposes.

While a REIT's income generally is tax-free (assuming it meets qualification criteria), US tax law prohibits, and taxes, sales of property held primarily for sale to customers in the ordinary course of business. To preserve the maximum tax advantage to the REIT and its investors, a REIT generally does not sell property to customers in its ordinary course of business.

Accounting for sales to customers – Topic 606

A seller accounts for customer sales under Topic 606 and recognizes revenue and cost of sales in its income statement. The seller follows this accounting regardless of whether the sale takes the form of a:

a. direct sale of real estate, including when real estate is the predominant component and has non-real estate components such as a ski resort;

b. sale of a financial asset (e.g. an ownership interest in an entity) that is in-substance real estate (e.g. an entity that holds only land); or

c. sale of a financial asset comprising an interest in an entity that holds an operating real estate asset that is a business (as defined under Topic 805). [360-20-15-2]

When a contract exists and the performance obligation is satisfied by transferring control of the property, Topic 606 requires the seller to derecognize the real estate (or in-substance real estate) and recognize the transaction price as revenue.

If a contract does not exist, the seller recognizes the cash received as a deposit liability, continues to report the real estate in its financial statements, depreciates it (if not held-for-sale), and tests it for impairment. [360-10-35, 360-10-40-3C, 45-9 – 45-10]

This reporting continues until a contract does exist and control of the property has transferred, or until the seller meets one of these conditions:

a. the seller has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the promised consideration has been received and is nonrefundable;

b. the contract has been terminated and the consideration received is nonrefundable; or

c. the seller has transferred control of the goods or services to which the consideration that has been received relates, has stopped transferring goods and services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the buyer is nonrefundable. [606-10-25-7]

Proposed scope changes for sales of noncontrolling interests that are in-substance real estate

The FASB has proposed changing the scope of Topic 860 (transfers and servicing) to include transfers of investments that are currently excluded from the financial assets' derecognition guidance because they are sales of in-substance of nonfinancial assets. Under the proposed guidance, the sale of that noncontrolling interest would be within Topic 860's scope regardless of whether the buyer is a customer or a noncustomer.

Topic 860 currently excludes an investor's sale of its noncontrolling interest in a real estate entity that is accounted for under the equity or cost methods if that investment is an in-substance nonfinancial asset. Those sales currently are within the scope of the revenue guidance if the buyer is a customer or the other income guidance if the buyer is a noncustomer. [860-10-15-4(e)]

Accounting sales to noncustomers – Subtopic 610-20

If the seller determines that the buyer is not a customer, it generally accounts for the sale under Subtopic 610-20 because real estate typically is a nonfinancial asset or an in-substance nonfinancial asset. The seller recognizes a gain or loss in the income statement for these noncustomer sales. If the real estate is not considered a nonfinancial asset (or an in-substance nonfinancial asset), other GAAP may apply. See Question A20. [360-10-40-3A]

To address real estate sales to noncustomers, Subtopic 610-20 incorporates many of Topic 606's principles that address sales to customers. Specifically, paragraphs 610-20-32-1 and 40-1 require a seller of a nonfinancial asset (or an in-substance nonfinancial asset) to a noncustomer to apply Topic 606's guidance to determine the:

a. existence of a contract; [606-10-25-1 – 25-8]

b. transaction price, including estimating variable consideration, constraining that consideration, and evaluating whether there is a significant financing component, noncash consideration and consideration payable to the customer; and [606-10-32-2 – 32-27, 32-42 – 32-45]

c. when an entity satisfies a performance obligation by transferring control of an asset. [606-10-25-30]

Currently Subtopic 610-20 does not incorporate Topic 606's guidance on identifying performance obligations (Step 2) and allocating transaction price (Step 4). However, the proposed ASU, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets,* clarifies that a seller would apply the revenue guidance on identifying distinct goods and services and allocating consideration to those distinct goods and services in noncustomer sales of nonfinancial assets or in-substance nonfinancial assets. The proposal also would require that the seller separately account for parts of a contract that are not assets of the entity to be derecognized, for example, guarantees or ongoing service contracts (see Question A20).

Under Subtopic 610-20, when a contract exists and the performance obligation is satisfied by transferring control of the property, the seller derecognizes the real estate (or in-substance real estate) and recognizes as a gain or loss the difference between the transaction price and the carrying amount of the real estate. In the proposed amendment to Subtopic 610-20, the carrying amount of liabilities assumed by the buyer also would be included in the consideration (subject to the constraint on estimating variable consideration in paragraph 606-10-32-11) used to compute the gain or loss.

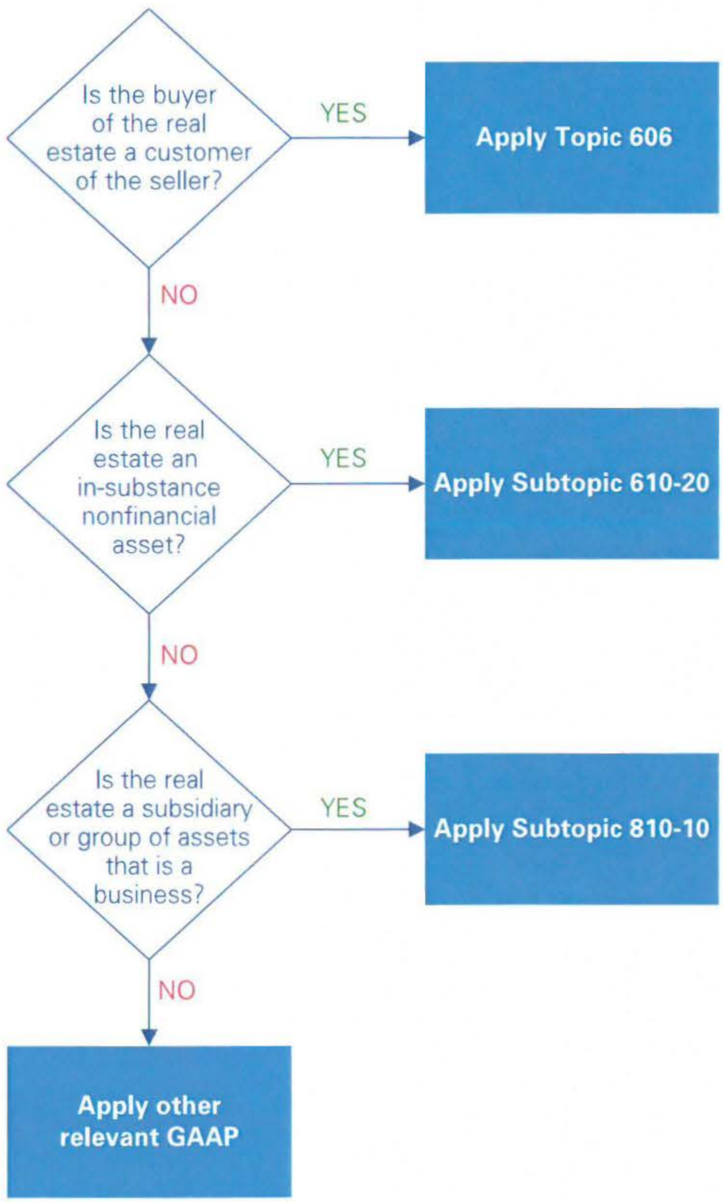
Similar to Topic 606, if a contract does not exist, the seller recognizes the cash received as a deposit liability, continues to report the real estate in its financial statements, depreciates it (if not held for sale), and tests it for impairment. [360-10-35, 360-10-40-3C, 45-9 – 45-10]

This reporting continues until a contract does exist and control of the property has transferred, or until the seller meets one of the conditions in paragraph 606-10-25-7.

A20. When is a noncustomer real estate sale considered a sale of an in-substance nonfinancial asset that is accounted for under Subtopic 610-20, versus a sale of a business that is accounted for under Subtopic 810-10?

In some cases, a noncustomer sale involving real estate-related assets (or a group or subsidiary holding real estate assets) may seem to have the characteristics of both the sale of a business (generally subject to Subtopic 810-10) and the sale of an in-substance nonfinancial asset (generally subject to Subtopic 610-20). Determining which Subtopic applies is important because that determination may affect the amount and timing of profit recognition.

This flowchart depicts the decision sequence.



Profit recognition under Subtopics 360-10 and 610-20

Paragraphs 360-10-40-3A and 40-3B (applicable to property, plant and equipment) state that derecognition of an in-substance nonfinancial asset should be accounted for under Topic 606 (if the sale is to a customer) or Subtopic 610-20 (if the sale is to a noncustomer). Under Subtopic 610-20, when a contract exists and control of the property is transferred, the seller derecognizes the real estate (or in-substance real estate) and recognizes as a gain or loss the difference between the transaction price and the carrying amount of the real estate (otherwise, the entity generally continues to report the real estate in its financial statements as discussed in Question A10).

The proposed amendment to Subtopic 610-20 also would include in the consideration used to compute the gain or loss the carrying amount of liabilities assumed by the buyer. The carrying amount would be subject to the constraint on estimating variable consideration (see the section *Proposed Clarifications to the Scope of Asset Derecognition Guidance*). [606-10-32-11]

Profit recognition under Subtopic 810-10

When the seller/parent *no longer* has a controlling financial interest in a business, it deconsolidates/derecognizes the subsidiary or group of assets. It then recognizes as a gain or loss the difference between the fair value of the consideration received (including the fair value of any noncontrolling interest retained post-sale) and the carrying amount of the subsidiary's assets and liabilities (as well as the carrying amount of any noncontrolling interest existing just before the sale).

When the seller/parent's ownership decreases, but it *retains* a controlling financial interest, the seller/parent recognizes an adjustment to equity equal to the difference between the fair value of the consideration received and the amount by which the noncontrolling interest is adjusted (i.e. there is no gain or loss recognized in consolidated net income or comprehensive income).

Interaction between Subtopics 810-10 and 610-20

Paragraphs 810-10-40-3A and 810-10-45-21A exclude the transfer of in-substance nonfinancial assets from Subtopic 810-10's deconsolidation and decreases in ownership guidance. Similarly, paragraphs 360-10-40-3A and 40-3B (applicable to property, plant and equipment) state that derecognition of an in-substance nonfinancial asset should be accounted for under Topic 606 (if the sale is to a customer) or Subtopic 610-20 (if the sale is to a noncustomer).

That guidance also says that derecognition of a subsidiary or group of assets is accounted for under Subtopic 810-10 only if that subsidiary is (a) not an in-substance nonfinancial asset, and (b) not sold to a customer. Therefore, the guidance on sales of an in-substance nonfinancial asset currently takes precedence over the deconsolidation/derecognition guidance for sales of a business (see the section *Proposed Clarifications to the Scope of Asset Derecognition Guidance)*.

What is an 'in-substance nonfinancial asset'?

An in-substance nonfinancial asset is not currently defined (the FASB recently proposed a definition; see the section *Proposed Clarifications of the Scope of Asset Derecognition Guidance*). However, the FASB retained the legacy guidance in 360-20-15-2 on identifying in-substance real estate, including the requirement to consider the nature of the entire real estate component that the entity is selling. [978-10-15-7 – 15-12]

The FASB retained this guidance to identify the scope of sale-leaseback transactions that remain subject to the guidance in Subtopic 360-20[1] and timeshare transactions within the scope of Topic 978. However, we believe this discussion about what constitutes in-substance

[1] Sale-leaseback transactions remain subject to Subtopic 360-20 only until a company adopts ASU 2016-02, *Leases* (Topic 842). Topic 842 supersedes Subtopic 360-20 and provides a single accounting model for sale-leaseback transactions that applies regardless of the nature of the asset transferred.

real estate remains relevant for concluding whether a sale of an asset with a real estate component to a noncustomer is within the scope of Subtopic 610-20 (in-substance nonfinancial assets) or Subtopic 810-10 (businesses).

Under paragraph 360-20-15-2, land plus property improvements and integral equipment are collectively considered in-substance real estate, so sales of those assets to noncustomers are accounted for under Subtopic 610-20. This guidance applies even if all (or part) of the operations of the property otherwise meet the definition of a business. Conclusions about whether an operating real estate property or an ownership interest in an entity with significant real estate assets is in-substance real estate (sales to noncustomers accounted for under Subtopic 610-20) is a matter of judgment, and all facts and circumstances should be considered.

We believe the sale of a single real estate property generally should be accounted for as the sale of a nonfinancial asset under Subtopic 610-20. Further, we believe if an entity has an ownership interest in an entity that holds a single real estate property, or substantially all of a multi-asset entity's value comprises real estate assets, selling the ownership interest likely would be a sale of an in-substance nonfinancial asset that would be accounted for under Subtopic 610-20. [610-20-15-2(b)]

Proposed clarifications to the scope of asset derecognition guidance

The FASB is reconsidering its guidance in its project on *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets* (previously referred to as *Clarifying the Definition of a Business Phase 2*).[2] In its *Clarifying the Definition of a Business (Phase 1)* project, the FASB proposed to change the definition of a business[3], which would result in most real estate being considered a nonfinancial asset rather than a business. In Phase 2, the FASB has proposed that Subtopic 610-20 would apply only when the property (in the form of a single nonfinancial asset or multiple, distinct in-substance nonfinancial assets) does not meet the definition of a business. When the property does meet the definition of a business, the seller would apply the deconsolidation and derecognition guidance in Subtopic 810-10.

There are also scope exceptions to the proposed guidance in Subtopic 610-20 for:

- nonprofit activities;
- sales to customers;
- transfers of investments (e.g. those accounted for under the equity method, see Question A10);
- transfers of subsidiaries in which substantially all of the fair value is not concentrated in nonfinancial assets;
- exchanges of nonfinancial assets for a controlling financial interest in a business (business combinations);
- exchanges between entities in the same line of business to facilitate sales to customers;
- nonreciprocal transfers;
- real estate sale-leaseback transactions;
- conveyances of oil and gas mineral rights; and
- exchanges of airline take-off and landing slots.

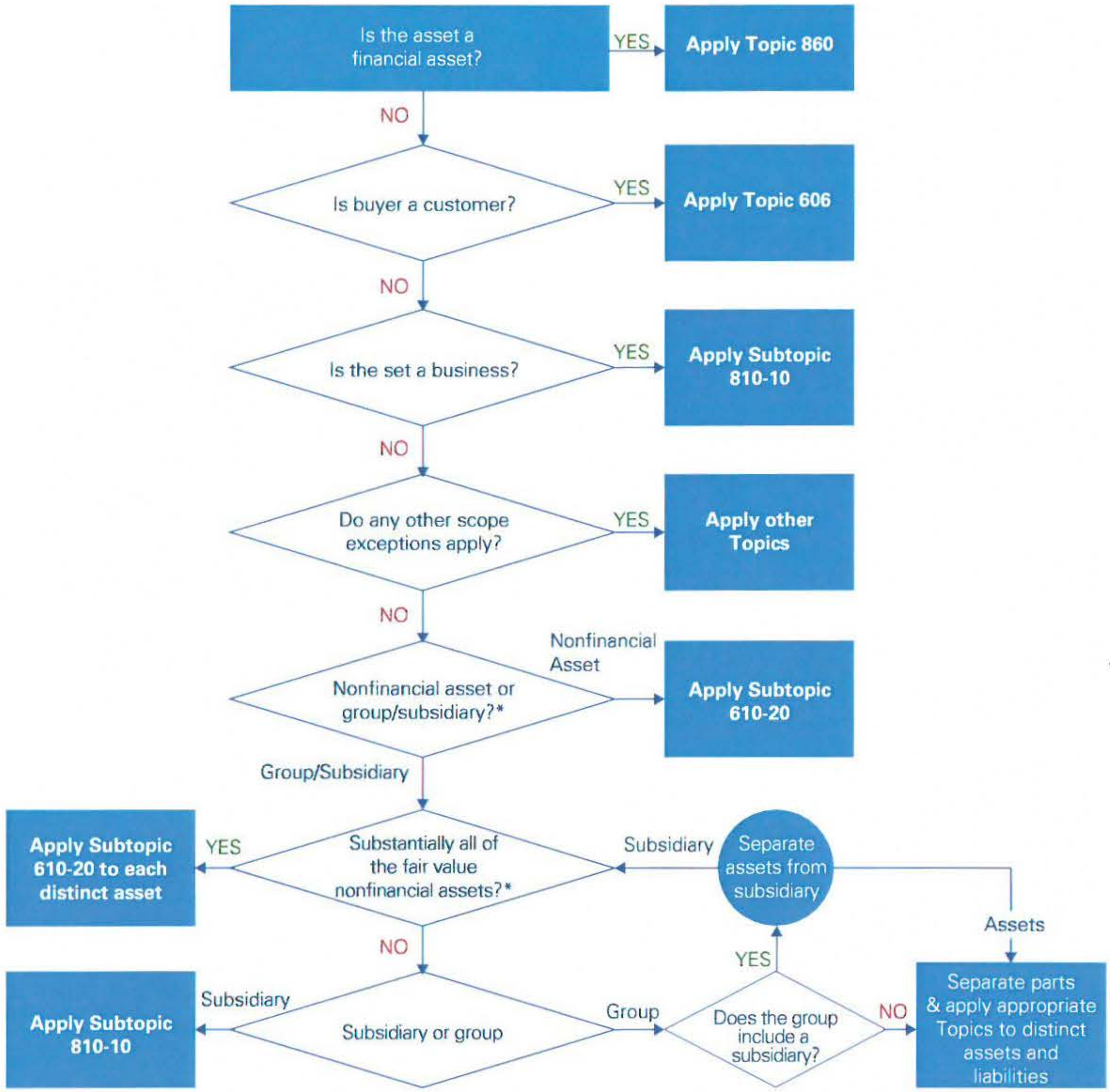
[2] For more information on this project, see KPMG's Defining Issues No. 16-21, FASB Proposes to Clarify Scope of Derecognition of Nonfinancial Assets.

[3] For more information on this project, see KPMG's Defining Issues No. 15-56, FASB Proposes to Clarify the Definition of a Business.

An asset would be an *in-substance nonfinancial asset* when (a) it is included either in a group (by contract) or a subsidiary, and (b) substantially all of the fair value (recognized and unrecognized, but excluding cash and cash equivalents) of that group or subsidiary is concentrated in nonfinancial assets (e.g. real estate and intangibles).

When substantially all of the fair value of the group or subsidiary is concentrated in nonfinancial assets:	All the assets in the group or subsidiary are considered in-substance nonfinancial assets, even if individual assets would be considered financial assets if they were sold independently.
When substantially all of the fair value of a *group* of assets is *not* concentrated in nonfinancial assets and the group is not a business:	The seller would apply the revenue guidance on identifying distinct goods and services and allocating consideration to those distinct goods and services. Then, the seller would account for each of the distinct goods and services under the applicable guidance (usually Subtopic 610-20) for the sale of distinct nonfinancial assets in the group.
When substantially all of the fair value of a *subsidiary* is *not* concentrated in nonfinancial assets and the subsidiary is not a business:	The seller would apply the guidance in Topic 810 on derecognition and decreases in ownership of businesses, which is required for subsidiaries when no other guidance applies. Topic 810 requires full gain or loss in earnings when a controlling financial interest is sold, and no gain or loss in earnings when a controlling financial interest is retained (i.e. the gain or loss is an adjustment to equity).

How a seller determines what guidance would apply when transferring a nonfinancial asset



* If the transfer includes other contractual arrangements that are not the assets of the seller to be derecognized (e.g. guarantees), those contracts are separated and accounted for under the applicable literature.

A30. How is Topic 606 applied when an entity sells property improvements (or integral equipment) and leases the underlying land to a customer? Does the answer differ if the transaction is with a noncustomer?

When a contract contains elements covered by different accounting Topics, the entity applies the guidance in those other Topics about how to separate and/or initially measure those elements. However, if the other guidance does not specify how to separate and/or initially measure one or more parts of the contract, then the entity applies Topic 606's separation and/or measurement guidance. [606-10-15-4]

The guidance in the current lease standard requires the seller/lessor to separate lease and non-lease components based on the relative stand-alone selling price. This requirement is consistent with the guidance in paragraphs 606-10-32-28 to 32-41. For example, in a sale of improvements together with a lease of the land on which the improvements are located, the seller/lessor separates the transaction into the lease of the land and the sale of the improvements and accounts for each separately. Revenue is recognized on the sale of the property improvements (or integral equipment) when control transfers to the customer (based on Topic 606's requirements). The lease of the land is accounted for under Topic 840, which requires lessors to classify land leases as operating leases if there is no automatic transfer of title to the lessee by the end of the lease term. [840-10-15-17 – 15-19]

Because Topic 840 generally addresses separation and measurement in transactions with lease and non-lease components regardless of whether the lessee is a customer, we believe this guidance applies equally to similar transactions with noncustomers. However, the presentation of the sale transaction would be treated differently. Subtopic 610-20 requires gain/loss presentation for noncustomer transactions while Topic 606 requires revenue and cost of sales presentation for customer transactions.

The FASB recently issued ASU 2016-02, which created a new Topic 842, *Leases*,[4] which will supersede Topic 840.

	Public business entities[5]	Other entities
Effective date	Annual and interim periods in fiscal years beginning after December 15, 2018	— Annual periods beginning after December 15, 2019 — Interim periods in fiscal years beginning after December 15, 2020
Early adoption	All entities can adopt Topic 842 immediately	

Topic 842, like Topic 840, includes guidance on separating lease and non-lease components. A lessor must separate a single contract into each separate lease component and non-lease component and allocate the consideration using the revenue accounting guidance, which specifies that the transaction price usually is allocated on a relative stand-along selling price basis. [606-10-32-28 – 32-41, 842-10-15-28 – 15-32, 15-38 – 15-42]

[4] For more information on ASU 2016-02, see Defining Issues 16-6, FASB Balloons Balance Sheet with New Lease Accounting Standard, and Leases: Issues in Depth.

[5] This includes (1) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and (2) employee benefit plans that file or furnish financial statements with or to the SEC.

Topic 842 requires a lessor to classify a lease as an operating lease unless the lessee:

a. effectively obtains control of the underlying asset as a result of the lease; or

b. does not obtain effective control but:

   - the present value of the sum of the lease payments ***plus***
   - any residual value guaranteed by the lessee (or any other third party unrelated to the lessor) not already reflected in the lease payments
   - ***equals*** or ***exceeds*** substantially all of the fair value of the underlying asset *and* it is probable that the lessor will collect the lease payments plus the amount needed to satisfy a residual value guarantee. [842-10-25-2 – 25-3]

A lessee effectively obtains control of the underlying asset when the lease meets any of the following criteria at lease commencement:

a. the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;

b. the lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise;

c. the lease term is for the major part of the remaining economic life of the underlying asset;

d. the present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset; or

e. the underlying asset is so specialized that it is expected to have no alternative use to the lessor at the end of the lease term. [842-10-25-3]

Comparison to legacy US GAAP

The sale of property improvements with an accompanying lease of the underlying land must be accounted for on a combined basis as a lease of the land and the improvements if the terms of the land lease either:

a. does not cover substantially all of the economic life of the improvements; or

b. is not for a substantial period (e.g. 20 years). [360-20-40-56 – 40-59, 55-33 – 55-43]

Under Topic 606 and the related amendments to Topic 840 (and Topic 842 when it becomes effective), the seller accounts for the sale of the improvements and the lease of the land separately.

Even when the sale of the improvements and the land lease are accounted for separately currently under Subtopic 360-20, the profit recognized on the sale of the improvements is a function of the:

— present value of the rental payments;
— term of the primary indebtedness on the improvements (if any);
— sale value of the improvements; and
— carrying amount of the improvements and the land.

Under Topic 606 and the related amendments to Topic 840 (and Topic 842 when it is effective), profit on the sale of the improvements is a function of the consideration allocated to the sale (usually based on the relative stand-alone selling prices of the two components) and the carrying amount of the improvements. In addition, the classification of the land lease under Topics 840 and 842 may differ because Topic 842 does not retain Topic 840's requirement to classify land leases as operating leases if there is no automatic transfer of title to the lessee by the end of the lease term.

A40. How does a seller apply Topic 606 when it guarantees the return of a customer's investment (or a return on that investment) for a limited or extended period in connection with the sale of real estate? Is the answer different if the transaction is with a noncustomer?

When a contract with a customer contains elements addressed by different Topics, if the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity first applies those separation and/or initial measurement requirements. [606-10-15-2, 15-4]

The seller first determines whether Topic 460, *Guarantees*, Topic 815, *Derivatives and Hedging*, or another Topic, applies to the guarantee. If the guarantee is within the scope of Topic 460 or Topic 815, the seller/guarantor initially recognizes and measures it at fair value using the initial measurement guidance in the applicable Topic. The seller then allocates the remainder of the consideration to the sale of the property. [606-10-15-2]

The following guarantee contracts are within the scope of Topic 460:

a. Contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

b. Contracts that contingently require a guarantor to make payments to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees).

c. Indemnification agreements (contracts) that contingently require a guarantor to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.

d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. [460-10-15-4]

Paragraph 460-10-55-2(b) states that a market value guarantee on a nonfinancial asset owned by the guaranteed party is an example of the type of contract described in paragraph 460-10-15-4(a). We believe seller guarantees, similar to market value guarantees, generally fall within the scope of Topic 460 and are separated from the sale transaction and initially measured at fair value. The seller allocates the remainder of the contract consideration to the sale of the real estate, which is subject to Topic 606's guidance on determining the transaction price.

Because the seller accounts for it separately, the guarantee does not affect the seller's ability to recognize revenue under Topic 606 when it transfers control of the real estate to the buyer. Guarantee-like arrangements not within the scope of Topic 460 or other accounting guidance are combined with the sale transaction and accounted for under Topic 606. These guarantee-like provisions may affect the:

a. amount of revenue recognized on the sale (because it may result in the transaction price being variable), or

b. timing of profit recognition if the provision is significant enough to conclude that control of the property has not transferred.

See Question F10 for discussion about control transfer and Question F60 for discussion about put options, which is another situation when a seller may retain control despite relinquishing physical possession of the property.

While Subtopic 610-20 currently does not address separating noncustomer multiple element transactions, we believe an entity selling to a noncustomer applies the same guidance as Topic 606. We hold this view because Subtopic 610-20 refers to Topic 606's transaction price and control transfer principles, which are most likely to be affected by a guarantee in connection with a sale. The FASB has confirmed this view in its proposed amendments to Subtopic 610-20. The FASB proposal would require that a seller separately account for parts of a contract that are not assets of the entity to be derecognized and cites as an example a guarantee accompanying the sale of real estate.

Comparison to legacy US GAAP

A guarantee of a buyer's return on or of investment in connection with a real estate sale, while generally meeting the definition of a guarantee in Topic 460, currently is accounted for in combination with the real estate sale under Subtopic 360-20 because it is scoped out of Topic 460. [460-10-15-17(g), 55-17(a)]

A seller that guarantees the return of the buyer's investment (or a return on that investment) for an extended period must account for the transaction as a financing, leasing or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the seller accounts for the transaction under the deposit method until the property's operating income covers all operating expenses, debt service and contractual payments. When all expenses are covered, profit is recognized based on the performance of the required services. [360-20-40-41]

Topic 606 changes this accounting because the guarantee by itself does not preclude the seller from recognizing a sale of the real estate; instead, the seller accounts for the guarantee separately under Topic 460 (if within its scope). The guarantee does, however, reduce profit on the sale of the real estate under Topic 606 because the fair value of the guarantee reduces the contract consideration allocated to the sale of the real estate. If the guarantee is not within the scope of Topic 460 or other Topics, it remains combined with the sale transaction and may affect the amount or timing of revenue (or profit) recognition.

A50. How is Topic 606 applied when a seller is required to initiate or support the operations of a property that is sold to a customer? Is the answer different if the transaction is with a noncustomer?

If the seller's obligation to support the operations of the property is within the scope of Topic 460 because it has the characteristics of a guarantee listed in Section 460-10-15 (e.g. the seller agrees to support the operations up to a break-even level of cash flows for a period of time), the seller separates the support obligation and initially recognizes and measures it at fair value under Topic 460's initial measurement guidance. The seller allocates the remainder of the contract consideration to the sale of the real estate and follows Topic 606's guidance on determining the transaction price. [460-10-30-2]

In our experience, support obligations generally have the characteristics of a guarantee that is within the scope of Topic 460, because they are analogous to a guarantee of the collection of scheduled contractual cash flows from financial assets or business revenue. [460-10-15-4(a), 460-10-55-2(d) – 55-2(e)]

Therefore, we believe most support obligations will be separated from the sale transaction and initially measured at the fair value of the guarantee. When the seller accounts for support obligations separately, it does not affect the seller's ability to recognize revenue under Topic 606 when or as the seller transfers control of the real estate to the buyer.

Guarantee-like arrangements not within the scope of Topic 460 or other Topics remain combined with the sale transaction accounted for under Topic 606 and may affect the:

a. amount of revenue recognized on the sale (because it may result in the transaction price being variable), or

b. timing of profit recognition if the provision is significant enough to conclude that control of the property has not transferred.

See Question F10 for discussion about control transfer and Question F60 for discussion about put options, which is another situation when a seller may retain control despite relinquishing physical possession of the property.

While Subtopic 610-20 currently does not address separating noncustomer multiple element transactions, we believe an entity selling to a noncustomer applies the same guidance. We hold this view because Subtopic 610-20 refers to Topic 606's transaction price and control transfer principles, which are most likely to be affected by a guarantee in connection with a sale. The FASB has confirmed this view in its proposed amendments to Subtopic 610-20. The proposal would require that a seller separately account for parts of a contract that are not assets of the entity to be derecognized and cites as an example a guarantee of break-even cash flows accompanying the sale of real estate.

Comparison to legacy US GAAP

An agreement to initiate or support the operations of a property in connection with a sale of that property, while generally meeting the definition of a guarantee in Topic 460, currently is accounted for in combination with the real estate sale under Subtopic 360-20 and therefore is scoped out of Topic 460. [460-10-15-17(g), 55-17(b)]

A seller accounts for a sale transaction as a financing, leasing or profit-sharing arrangement if it is required to initiate or support operations or continue to operate the property at its own risk (or presumed to have such a risk) for an extended period of time and provides conditions that, if present, presume support for an extended period of time. If support is required (or presumed to be required) for a limited time, a seller must recognize profit on a proportional performance basis as the services are provided. [360-20-40-43 – 40-44]

Performance of those services is measured by the costs incurred and to be incurred over the period during which the services are performed (i.e. on a cost-to-cost basis). The seller begins to recognize profit when there is reasonable assurance that the future rent receipts will cover operating expenses and debt service, including payments due to the seller under the terms of the transaction.

Topic 606 changes the accounting because the support obligation by itself does not preclude the seller from recognizing a sale of the real estate; instead, the seller accounts for the support obligation separately under Topic 460 (if within its scope). The guarantee does, however, reduce profit on the sale of the real estate under Topic 606 because the fair value of the support obligation reduces the contract consideration allocated to the sale of the real estate. If the support obligation is not within the scope of Topic 460 or other Topics, it remains combined with the sale transaction and may affect the amount or timing of revenue (or profit) recognition.

Example A50: Property sale with support obligation

Description of the arrangement

ABC Corp. sells a newly constructed property with a cost of $1,200,000 to DEF Corp. for $2,000,000 in cash. ABC guarantees the cash flows of the property will be sufficient to meet all the property's operating needs for the first three years after the sale date. The fair value of the guarantee at the sale date is $30,000 and there is no other variable consideration.

Evaluation

Because the support obligation is a guarantee within the scope of Topic 460, it is initially separated from the real estate sale and measured at fair value. ABC allocates $30,000 of the $2,000,000 contract consideration to the guarantee, and allocates $1,970,000 to the sale of the property, which is the transaction price.

ABC recognizes a profit of $770,000 ($1,970,000 less $1,200,000 cost) on transferring control of the property. The guarantee continues to be accounted for separately under Topic 460 and does not affect the profit recognized on the sale. ABC recognizes subsequent changes in the guarantee's carrying amount outside of revenue (or gain on sale if the buyer is not a customer).

A60. What is the unit of account under Topic 606 for sales of condominium units within a condominium project (or similar structure)?

Topic 606 generally specifies the unit of account is an individual contract with a customer. Further, paragraph 606-10-55-180 contemplates that individual contracts with customers to construct individual units in a multi-unit residential complex are accounted for separately. Paragraph 606-10-10-4, however, provides a practical expedient allowing an entity to apply the guidance to a portfolio of contracts (or performance obligations) with similar characteristics, but only if the entity reasonably expects the effect on the financial statements to not differ materially from applying the guidance to the individual contracts.

We believe it may be difficult for an entity to demonstrate a reasonable expectation that the effect of using a project approach is materially the same as using an individual contract approach because the:

a. control of the individual units likely will transfer at different points in time (see Question F40 about the pattern of control transfer in unit sales); and

b. transaction prices and the fulfillment costs of individual units within a project likely will be different.

Comparison to legacy US GAAP

If an entity separately sells individual units in a condominium project, it must recognize profit using the percentage-of-completion method on the sale of individual units, if the sale meets the following conditions:

— construction is beyond a preliminary stage;

— the buyer is committed to the extent of being unable to require a refund except for non-delivery of the unit;

— sufficient units have already been sold to assure that the entire property will not revert to rental property;

— sale prices are collectible; and

— aggregate sale proceeds and costs can be reasonably estimated. [360-20-40-50]

Sellers/developers may have historically applied the percentage-of-completion method by measuring progress on a cost-to-cost basis relative to the project as a whole, and applying that measure of progress to the estimated gross profit (revenue and expense) on an individual unit sale. The unit is considered sold if the above criteria are met, which typically occurs before closing.

Under Topic 606 sellers/developers generally are required to separately account for each contract with an individual customer unless they reasonably expect the effect on the financial statements of using a portfolio (or project) approach will not differ materially from applying the guidance to the individual contracts. As explained previously, we expect that the portfolio approach will not be appropriate for most condominium projects. See chapter F. Step 5: *Recognize Revenue* for discussion of the pattern of control transfer of real estate sales and Question F40 for discussion of unit sales.

B Step 1: Identify the contract

B10. What consideration should an entity give to the buyer's initial and continuing investments when evaluating if a seller of real estate has a contract with a buyer?

Unlike current guidance for real estate sales, Topic 606 contains no explicit initial or continuing investment requirements for the buyer. The seller must evaluate whether the parties are "committed to perform their respective obligations" and whether it is "probable [the seller] will collect substantially all of the consideration to which it will be entitled" in exchange for property transferred to the buyer.

The objective of evaluating the customer's ability and intention to pay is to assess whether there is a substantive transaction between the seller and the buyer. This assessment is partially forward looking, which requires the seller to use judgment and consider all facts and circumstances, including the seller's customary business practices and its knowledge of the buyer. [606-10-25-1]

Seller's considerations when evaluating whether collectibility is probable

Payment terms that suggest a significant uncertainty about the buyer's intention and ability to fulfill its obligations	Do the payment terms reflect inherent uncertainty about the buyer's intention to fulfill its obligations? — Small down payment relative to the overall contracted price — Nonrecourse, seller-provided financing — Customer-provided collateral or guarantees that are illiquid or have highly variable or unobservable fair value — Continuing periodic payments that extend beyond: - a customary financing period for similar transactions - the property's estimated useful life — No periodic payments required — Guarantees provided by lower-rated counterparties
Importance of the property to the buyer's operations	— Does the buyer's business model and reasons for entering into the transaction raise doubt about its intention to follow through with its obligations? — Does the buyer need the property to operate its business, which likely indicates that it would have a greater commitment to perform than if the purchase was made for speculative investment purposes?
Prior experience	— Does the seller have prior experience with the buyer (or a similar class of buyer) for the same or similar transaction that raises questions about the buyer's intent and ability to perform? — Has the seller previously chosen not to enforce its contractual rights in similar contracts with the buyer (or buyer class) under similar circumstances? — Is the seller's receivable subject to future subordination?

An entity should not view these factors in isolation. Instead, the entity should evaluate the factors collectively and evaluate all relevant facts and circumstances. No single factor determines whether the customer is committed to perform or collectibility is probable. An entity that refers to the legacy guidance in Subtopic 360-20 on initial and continuing investments as an indicator of whether collectibility is probable under Topic 606 should not consider these thresholds as safe harbors or bright lines. The seller's ability to later repossess the property after it transfers control to the buyer at a point in time should not be considered when assessing its ability to mitigate its credit risk exposure. [606-10-55-3C]

If the transaction does not meet criteria in paragraph 606-10-25-1, the arrangement is not a contract and the seller:

— needs to continue to report the nonfinancial asset on its statement of financial position;

— depreciates it if it is not held for sale under paragraphs 360-10-45-9 – 45-10; and

— tests it for impairment under Section 360-10-35. [360-10-40-3C]

The seller then accounts for cash collected as a deposit liability until the conditions for a contract exist and the seller transfers control of the property to the buyer or until it meets one of the following conditions: [606-10-25-6 – 25-8]

a. The seller has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the promised consideration has been received and is nonrefundable;

b. The contract has been terminated and the consideration received is nonrefundable; or

c. The seller has transferred control of the goods or services to which the consideration that has been received relates; the entity has stopped transferring goods and services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services; and the consideration received from the buyer is nonrefundable. [606-10-25-7]

If the transaction subsequently meets the criteria in paragraph 606-10-25-1, revenue or gain is recognized by applying the guidance in Topic 606 (customer transactions) or Subtopic 610-20 (noncustomer transactions).

Paragraphs 606-10-55-95 to 55-98 illustrate the collectibility analysis in the context of a real estate sale when a real estate developer sells a building and provides long-term, nonrecourse financing for 95 percent of the sales price. The buyer expects to repay the loan primarily from income derived from its restaurant business and lacks other income or assets to repay the loan. Additionally, the restaurant business faces significant competitive risks and the buyer has limited industry experience. Because of the uncertainty associated with the buyer's ability and intention to pay, the seller concludes that the criteria in paragraph 606-10-25-1 are not met.

At the sale date (and each reporting period), the seller must evaluate conditions (a) through (c) in paragraph 606-10-25-7 to determine how to account for the nonrefundable deposit, until it meets the criteria in paragraph 606-10-25-1.

We believe the seller would conclude at the sale date that the first two conditions under paragraph 606-10-25-7 are not met because the:

a. seller has not received substantially all of the consideration; and

b. contract has not been terminated.

We also believe the third condition may not be met because the seller may conclude it has retained control of the building based on its analysis of the control indicators in paragraph 606-10-25-30. Paragraph 360-10-40-3C specifies that the seller does not derecognize the asset when the criteria for a contract in paragraph 606-10-25-1 are not met. See additional discussion of control transfer in Question F10.

The seller would recognize the nonrefundable deposit received from the buyer as a deposit liability. The seller would not derecognize the asset, and would not recognize a receivable for the remainder of the sales price. The seller must continue to assess the contract to determine whether the paragraph 606-10-25-1 criteria are subsequently met, or one of the conditions in paragraph 606-10-25-7 exists. We believe the following situations will most commonly occur in real estate sales when a contract does not exist at the sale date.

— A contract subsequently does exist under paragraph 606-10-25-1 because the buyer has established a consistent payment history, has established other sources of funds, or accumulated funds to reduce the risk of nonpayment. The seller derecognizes the building and recognizes revenue (or gain or loss) on the sale at the point in time control transfers.

— A contract does not exist under paragraph 606-10-25-1, but the parties terminate the arrangement and the seller repossesses the property. The seller recognizes the nonrefundable deposit in income.

The guidance on evaluating the existence of a contract (and the accounting if a contract does not exist) applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

Paragraph 360-20-40-5 requires, among other things, that a buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property to be able to recognize profit by the full accrual method. Adequacy of the buyer's initial investment is measured both by its composition and size compared with the sale price of the property. [360-20-40-10, 40-13, 40-18]

The buyer's continuing investment does not qualify unless it meets certain conditions. The buyer must be contractually required to pay annually on its total debt incurred to buy the property an amount at least equal to the level annual payment that it would be required to pay, including interest, over (a) no more than 20 years for land, or (b) the customary amortization term of a first mortgage loan extended by an independent, established real estate lending institution. [360-20-40-19]

If the buyer's initial or continuing investment is not adequate, the seller must apply the installment, cost recovery or deposit method to account for the sale, depending on the likelihood of recovery if the buyer defaults. [360-20-40-31]

Topic 606 changes the accounting for transactions where a contract exists based on qualitative considerations, but would not otherwise meet the initial and continuing investment requirements of Subtopic 360-20. Under Topic 606, this contract results in revenue recognition (or gain recognition in a noncustomer transaction under Subtopic 610-20) when or as control transfers to the buyer. In contrast, under Subtopic 360-20 this contract results in application of the installment, cost recovery or deposit method.

The results of applying Topic 606 may also differ from the current accounting under Subtopic 360-20, even when a contract does not exist. Topic 606 prohibits using the installment or cost recovery methods. Instead, it requires that the entity use a form of the deposit method. However, the application of the deposit method differs between Subtopic 360-20 and Topic 606/ Subtopic 610-20.

When an entity applies the deposit method under Subtopic 360-20, if a portion of the cash received is contractually designated as interest (versus principal) and is nonrefundable, then those interest receipts offset the seller's carrying charges (property taxes and interest on existing debt) on the property. An entity records its receipts of principal (and interest in excess of carrying charges on the property) as a deposit liability.

Under Topic 606/Subtopic 610-20, all amounts received are recorded as a deposit liability.

C Step 2: Identify the performance obligations

C10. Is the sale of an undivided interest in the common areas where the seller/developer may build future amenities considered a separate performance obligation from the sale of a condominium unit or residential lot when the undivided interest is transferred to the customer in the sales transaction? Does the answer change if the seller/developer does not transfer the undivided interest but it will transfer future amenities to a third party?

A seller accounts for a good or service as a performance obligation if the good or service promised to the customer is distinct from other goods or services promised in the contract. A good or service is distinct if the:

a. customer can benefit from the good or service either on its own or with other resources that are readily available to the customer (i.e. the good or service is capable of being distinct), and

b. entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. distinct in the context of the contract). [606-10-25-19]

Capable of being distinct

A good or service meets criterion (a), capable of being distinct, if it could be "used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits." The fact that the entity regularly sells a good or service separately indicates that a customer could benefit from the good or service on its own or with other readily available resources. [606-10-25-20]

Distinct in the context of the contract

The seller's objective when assessing whether a promise is distinct in the context of the contract (criterion (b)) is to determine whether the nature of its overall promise is to transfer each of the goods or services, or whether the promise is to transfer a combined item to which each of the promised goods or services are inputs. [606-10-25-21]

These factors indicate a good or service is not distinct in the context of the contract:

— the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract;

— one or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract; or

— the goods or services are highly interdependent or highly interrelated (i.e. each one is significantly affected by the other goods or services).

We do not believe the seller/developer's undivided interest in the common areas is capable of being distinct because it cannot generate economic benefits on its own or with other readily available resources.

The common areas, regardless of whether the amenities have been completed, generally:

a. cannot generate independent economic benefits to the buyer (the undivided interest is not practically separable from the fee interest in the unit or lot); and

b. the buyer is unable to purchase (or not purchase) the undivided interest without the condominium unit or lot.

Therefore, the sale of the unit or lot and the accompanying transfer to the customer of the undivided interest in the common area would be a single performance obligation.

We believe this conclusion is consistent with the FASB's guidance that says that a developer may need to include in its measure of progress toward completely satisfying its performance obligation to construct an individual unit within a multi-unit residential complex its progress on completing construction of the common areas. [606-10-55-180]

We also believe this conclusion is consistent with the cost guidance in Subtopic 970-340 that requires developers to allocate to the benefitted land parcels the common costs of the amenity. This guidance was not amended by Topic 606 or Topic 340.

Accounting for amenity costs

The FASB's industry guidance in Subtopic 970-340 on accounting for amenity costs applies because the future amenity is being sold or transferred in connection with the sale of individual units by transferring an undivided interest. In this situation, the developer should allocate the costs that exceed the anticipated proceeds as common costs to the land parcels that benefitted from the development, or probably will benefit, because the amenity is clearly associated with the sale of the project. The common costs include the developer's expected future operating costs until the amenity is assumed by the buyers of the units. Before the amenity is substantially complete and available for use, operating income (loss) is included as a reduction of (or addition to) common costs. See additional discussion in Question F40 about the timing of revenue recognition for sales of condominium units (and other similar structures). [970-340-25-9 – 25-11]

Transferring future amenities to a third party

When the seller/developer transfers future amenities to a third party (e.g. a homeowner's association (HOA), municipality or community development district) instead of transferring them to the customer as an undivided interest, it analyzes the transfers differently. Based on discussions with the FASB staff, we believe that those third parties generally are not extensions of the customer because they are unrelated to the customer and the customer does not control the amenities before or after the transfer.

While an individual homeowner often has an obligation to pay fees to third-party transferees such as HOA dues or municipal taxes, and may have some rights to participate in their operation, such as becoming a board member, appealing fee or tax assessments, or obtaining and reviewing governing documents or financial data, the individual generally does not have an equity interest or the ability to control the third party or the amenity either before or after the transfer. In this situation, the promise associated with the future amenity would not be considered part of the customer's contract to purchase the property because the amenities will be transferred to an unrelated party. Therefore, delivery of the amenity would not be considered a performance obligation in the contract with the customer.

Accounting for amenity costs

We believe the guidance in paragraph 970-340-25-9(b) on accounting for amenity costs applies to these situations because the developer is selling or transferring the future amenity separately to the third party. The amount of capitalizable costs (incurred before the amenity is substantially complete and available for use) that exceeds the estimated fair value at the date of substantial physical completion should be allocated as common costs to the land parcels that benefitted and to those for which development is probable. Capitalizable costs are reduced for operating income (or are increased for operating loss) generated by the amenity before it is substantially complete and available for use. Operating income (or loss) generated by the amenity after it is substantially complete and available for use is included in operating results. A later sale of the amenity at an amount different than the estimated fair value at substantial completion, less any depreciation, results in a gain or loss in net income in the period in which the sale occurs. [970-340-25-10 – 25-11]

In the scenario described, the third party typically pays little or no consideration on transfer of the amenity. Therefore, we believe that the developer would treat as common costs all the costs associated with the amenity that are not expected to be recovered on transfer to the HOA or municipality.

C20. Does the sale of land and the agreement to construct property improvements comprise multiple performance obligations? Is the analysis different if the buyer is not a customer?

It depends. As discussed in Question C10, a seller accounts for a good or service as a performance obligation under paragraph 606-10-25-19 only if the good or service promised to the customer is distinct (i.e. capable of being distinct and distinct in the context of the contract) from other goods or services in the contract.

Capable of being distinct

When evaluating whether the transfer of the land and the construction contract are capable of being distinct, the seller/developer considers whether the land alone could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefit. For example, could the land alone be sold, developed by another party or leased to others?

The seller/developer also considers whether the property improvements that are the output of the construction contract could independently generate economic benefits. For example, could the property improvements be sold independently (perhaps if a buyer leased the underlying land) or leased?

The seller/developer also considers whether it (or a similar party) regularly sells land or construction services separately. [606-10-25-20]

We believe a seller/developer often may conclude that the sale of the land and construction service contract are capable of being distinct, but it needs to consider all the facts and circumstances. See Question C10 about how a seller/developer may evaluate this criterion in a property sale with an accompanying undivided interest in the common areas.

Distinct in the context of the contract

When the seller/developer evaluates whether the sale of the land and the construction contract are distinct in the context of the contract, its objective is to determine whether the nature of its overall promise is to transfer each of the goods or services, or whether the promise is to transfer a combined item to which the promised goods or services are inputs.

Factors that indicate a good or service is *not* distinct in the context of the contract, include, but are not limited to:

- **Indicator a** – the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract;
- **Indicator b** – one or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract; or
- **Indicator c** – the goods or services are highly interdependent or highly interrelated (i.e. each one is significantly affected by the other goods or services).

Indicator a

While land appears to be an input to delivering a property improvement, the land with the property improvements may not be the combined output specified in the contract. The land transfer and property improvement construction may be separate promises in the contract.

For example, these contract terms may suggest the promises are separate:

- the stated contract consideration (not necessarily the transaction price) for the land sale may be independent of the construction service consideration;
- the timing for delivery of each promise may be different because the title to the land transfers to the buyer before construction begins; or
- there are dispute resolution or default provisions associated with the land sale, the construction contract, or both, that do not affect the terms of the other promise.

Indicator b

Whether property improvements significantly modify or customize the land may depend, in part, on the nature of the improvement and the characteristics of the land. For example, certain land parcels may be expected to have largely the same value with or without the property improvements (e.g. one in a unique location and/or zoned for a particular use). Other land parcels may not require significant site preparation (demolition, clearing, grading or excavation) so the construction of the improvements may not significantly modify or customize the land.

Indicator c

This indicator focuses on whether the promises affect each other to such an extent that delivery/satisfaction of one without the other, and vice versa, would significantly affect the value or utility of the delivered/satisfied promise.

The FASB's guidance provides one example of highly interrelated promises when an entity grants a customer an antivirus software license along with when-and-if-available updates. The updates occur frequently and are critical to the continued utility of the software because without them the customer's ability to benefit from the software would decline significantly. These promises are not distinct in the context of the contract because the license and its updates are inputs to a combined output of antivirus protection. The updates significantly modify the functionality of the software to ensure that it protects the customer from new viruses and are integral to maintaining the software's utility. The license and the updates fulfill a single promise to the customer, which is to provide protection from computer viruses for three years. We believe that the FASB intended this example to illustrate a very narrow fact pattern that is specific to certain software-license arrangements. [606-10-55-140D – 55-140F]

The FASB provides another example of an entity contracting with a customer to sell a piece of equipment with installation services that are not complex and are capable of being performed by alternative service providers. In this scenario, the promises are distinct in the context of the contract for the following reasons.

a. The entity is not providing a significant integration service. Instead, the entity has promised to deliver the equipment and install it. The entity would be able to fulfill its promise to transfer the equipment separately from its promise to install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.
b. The installation services will not significantly customize or modify the equipment.
c. Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfill its promise to transfer the equipment independently from its promise to provide installation services. Because the equipment and the installation services do not significantly affect each other, they are not highly interdependent or highly interrelated. [606-10-55-150A – 55-150D]

Even if the customer is contractually required to use the entity's installation services, the promises are still distinct because the contractual requirement does not change the characteristics of the goods or services, nor does it change the entity's promises to the customer. [606-10-55-150E – 55-150F]

When applying this guidance to land sales with accompanying development contracts, we believe seller/developers often will conclude that the land and construction services are not highly interdependent or highly interrelated because generally a customer could benefit independently from the land and construction services. For example, a customer could purchase the land and hire another party to perform the construction services and conversely could purchase, lease or redeploy other land on which the developer could construct the improvements. While the contract allows the customer to benefit from the construction services only after it has obtained control of the land, generally the seller/developer can fulfill its promise to transfer the land independently of its promise to perform the construction services.

However, there may be situations when the land sale and the development contract are highly interdependent or interrelated. This could occur when the entire project is so complex or specialized that the value of the combined output (i.e. the completed property) relies primarily on the seller/developer's proprietary knowledge, skill or position in the market. In these unusual situations, the parties to the contract also likely would conclude that indicator (a) is met because the seller/developer performs a significant service of integrating the land purchase and the construction services to deliver a transformed combined output for which the buyer has contracted.

A contractual requirement to use the same seller/developer for the land sale and construction services does not affect the conclusion about whether the promises are distinct. [606-10-55-150E – 55-150F]

Careful consideration of the total contract and all relevant facts and circumstances about the delivery of goods or services to the customer are critical when evaluating the principle and applying the indicators in paragraph 606-10-25-21.

We believe the guidance on identifying performance obligations for a customer transaction also applies by analogy to noncustomer transactions even though Subtopic 610-20 currently does not specifically refer to paragraphs 606-10-25-14 to 25-22. The proposed ASU, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, clarifies that a seller would apply the revenue guidance on identifying distinct goods and services and allocating consideration to those distinct goods and services in noncustomer sales of nonfinancial assets or in-substance nonfinancial assets. The proposal also would require that the seller separately account for parts of a contract that are not assets of the entity to be derecognized such as guarantees or revenue contracts. See additional discussion of this project in Question A20.

See additional discussion in Question F30 about the timing of revenue recognition for land sales with accompanying construction contracts.

Comparison to legacy US GAAP

Paragraphs 360-20-40-61 to 40-64 address real estate sale contracts with future development required by the seller/developer. If the future costs of development can be reasonably estimated at the time of sale, the seller/developer allocates the profit at the same rate to the sale of the land and the development services. Profit allocated to the land sale is recognized when the land is sold, assuming the other criteria for recognition of profit by the full accrual method are satisfied. Profit allocated to the development services is recognized after the sale using the percentage-of-completion method as development and construction proceed.

Under Topic 606, a seller/developer first determines if the contract comprises one or two performance obligations (see Question C20 in Step 2). After the performance obligations are identified and the overall transaction price is determined (Step 3), the seller/developer allocates the transaction price to each performance obligation (Step 4). The seller/developer evaluates each performance obligation to determine whether it is satisfied (and therefore revenue should be recognized) over time or at a point in time (Step 5). See additional discussion in Question F30.

The evaluation process may result in differences from the accounting prescribed by paragraphs 360-20-40-61 to 40-64 for the following reasons.

a. Subtopic 360-20 requires identification of a single unit of account compared to the Step 2 process in Topic 606 that may result in more than one unit of account.
b. Step 3 of Topic 606 defines the overall transaction price differently than Subtopic 360-20 including the requirement to estimate variable consideration in the contract.
c. Subtopic 360-20 requires an entity to recognize the same rate of profit on the land sale and the development contract. In contrast, Step 4 of Topic 606 requires the entity to allocate the transaction price to the performance obligations (if there is more than one) based on relative stand-alone selling prices. This allocation can result in different profit margins on each performance obligation.
d. Subtopic 360-20 requires the use of percentage-of-completion to recognize revenue, while Step 5 of Topic 606 requires an entity to evaluate each performance obligation to determine if it is satisfied over time or satisfied at a point in time. [360-20-40-61]

This accounting may create differences in the amount and timing of revenue recognized on the property sale and the development contract, particularly when the seller/developer identifies two performance obligations. In the less likely scenario that the sale and development are a single performance obligation satisfied over time and the seller/developer uses a cost-to-cost input method for measuring the progress, the accounting under Topic 606 and Subtopic 360-20 may be similar (see Question F30).

C30. How should any entity analyze the number of performance obligations in a typical property management services contract?

As discussed in Question E10, the manager first must determine whether the nature of the property management services is to provide a single, integrated service offering for a defined period of time or to perform a specified set of activities during the period. Important to this determination is whether the activities the manager will perform to fulfill the performance obligation are indeterminate (e.g. even if the type of activities are generally understood, the quantity and mix of activities that will need to be performed to fulfill the obligation are unknown), or are known upfront (e.g. the manager will do X, Y and Z activity once each week for three years).

The manager must then determine whether the contractual service period can be subdivided into smaller time increments during which the manager's activities are substantially the same in each time increment. For example, could a three-year property management services contract be subdivided into time periods like three annual periods or 36 monthly periods?

After subdividing the service period into time increments, the manager must evaluate whether those identified increments are distinct from each other under paragraphs 606-10-25-19 and 606-10-25-21. If so, the manager considers the services a series of distinct services that are accounted for as a single performance obligation.

The FASB illustrates this guidance in an example where property management services are accounted for as a single performance obligation under the series guidance in paragraphs 606-10-25-14 to 25-15. [606-10-55-157B – 55-157E, Ex 12A]

The example reaches its conclusion because:

a. each day's property management services are substantially the same because the manager provides the same overall service each day, even if the underlying tasks or activities vary (e.g. cleaning services, leasing or reservation services, property maintenance);
b. each day of property management services meets the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time because the customer simultaneously receives and consumes the benefits provided by the manager as it performs (see the discussion of the over-time criteria in Question F20); and
c. the same method is used to measure progress toward complete satisfaction of the performance obligation because each day's obligation to provide property management services typically is measured using a time-based approach. [606-10-25-15]

For more information see the following questions:

— D30 – determining the transaction price when the property management services contract accompanies a property sale;

— E10 – allocating the transaction price when the property management services contract accompanies a property sale; and

— F30 – recognizing revenue for variable consideration in a property management services contract.

D Step 3: Determine the transaction price

D10. How does a seller's right to participate in a property's future profits affect the determination of the transaction price for the sale of that property?

The seller generally treats its right to future profits as variable consideration and estimates it upfront to determine the transaction price (the amount of consideration to which it expects to be entitled). The seller would not estimate its right to future profits upfront as part of the property sale's transaction price if:

a. it must allocate it entirely to another performance obligation, or to distinct goods or services within a series of distinct goods or services that are accounted for as a single performance obligation under paragraph 606-10-32-40, or

b. it may recognize revenue in the amount to which the entity has a right to invoice under the paragraph 606-10-55-18 practical expedient.

Variable consideration included in the transaction price is subject to a constraint (see paragraphs 606-10-32-11 to 32-14) and is regularly reassessed until the uncertainty is resolved. A seller may only include its estimate of its share of future profits to the extent that it is probable that a significant reversal in the cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.

Paragraph 606-10-32-12 requires a seller to consider both the likelihood and the magnitude of a potential revenue reversal and includes the following factors that could increase the likelihood or the magnitude of a revenue reversal.

- The amount of consideration is highly susceptible to factors outside the seller's influence. Those factors may include market volatility, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- The seller does not expect resolution to the uncertainty about the amount of consideration for a long time.
- The seller's experience or other evidence with similar contracts is limited, or that experience or other evidence has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The seller must estimate the transaction price in light of the specific facts and circumstances of the arrangement and cannot default to a conclusion that the variable consideration is fully constrained until the uncertainty is resolved. The seller will update the estimated transaction price each reporting period to reflect the current circumstances at each reporting date.

The guidance on determining the transaction price applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

If the seller will participate in future profits from the property without risk of loss (such as participation in operating profits or residual values without further obligation), and the sale otherwise qualifies for recognition of profit by the full accrual method, the contingent future profits are recognized when realized. Application of Topic 606/Subtopic 610-20 may result in earlier revenue (or gain) recognition for these provisions when the cumulative revenue recognized, inclusive of an estimate of the seller's share of future profits, is probable of not being subject to a risk of significant revenue reversal. In many cases, the constraint will not reduce the variable consideration associated with the future profits interest all the way to zero. [360-20-40-64]

When inclusion of those future amounts in the transaction price is not appropriate because a significant revenue reversal could occur, the accounting under Topic 606/Subtopic 610-20 may be substantially equivalent to current accounting under Subtopic 360-20. However, we believe that in many cases, variable consideration will not be fully constrained until the uncertainty is resolved.

Example D10: Sale of property with future profits interest

Description of the arrangement

ABC Corp. sells a newly constructed retail property with a cost of $1,200,000 to DEF Corp. for $2,000,000 in cash and a right to receive 5% of future operating profits from the property over a 10-year earn-out period. ABC has no ongoing performance obligation related to the operations of the property.

Because the in-place leases have fixed payments for the first two years of the earn-out period, ABC concludes it is probable that it will receive a payout of $50,000 in variable consideration for years one and two. It bases its belief on the contractual, fixed lease payments in those years and its experience with similar properties and tenants.

However, ABC is less certain about its expected payouts in years 3 through 10 because the lease payments that the property buyer will receive shift from fixed payments to contingent payments based on the lessees' underlying third-party sales. While ABC is not guaranteed a minimum payout in years 3-10, it can estimate its expected payout based on its experience with similar properties and tenants.

ABC believes it will collect at least $110,000 in earn-out payments in years 3-10 and concludes it is probable that a significant reversal of $2,160,000 will not occur. This amount is the contractual selling price of $2,000,000 plus $160,000 of the variable consideration for the earn-out period. ABC does not believe it has a basis to reasonably estimate any additional earn-out amounts because of its level of uncertainty about receipts in excess of $160,000.

Evaluation

Profit of $960,000 ($2,000,000 contractual selling price + $160,000[6] in variable consideration – $1,200,000 cost) is recognized when control of the property transfers. The $160,000 of variable consideration is included in the transaction price because it is probable a significant reversal in revenue of $2,160,000 (the cumulative revenue recognized) will not occur.

ABC continually assesses the variable consideration, considering the constraint, and revises its estimates accordingly.

[6] Note the impact of the time value of money is not analyzed when consideration is variable and the timing of that consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or entity (see paragraph 606-10-32-17(b)).

D20. Is a change in estimate relative to the measure of progress toward satisfaction of the performance obligation on a construction contract subject to the revenue recognition constraint?

The objective of the constraint on variable consideration is to recognize revenue only to the extent it is probable the cumulative amount of revenue recognized is not subject to a risk of significant revenue reversal *due to variability in the transaction price*. While a construction contractor may experience revenue reversals when it changes its estimate of progress toward complete satisfaction of a performance obligation, these reversals do not represent changes in the ultimate consideration to which the developer is entitled. [606-10-32-11 – 32-14]

The risk associated with a change in timing of total revenue is not evaluated under the constraint. However, significant changes in timing may:

a. call into question the contractor's ability to reasonably estimate its progress as discussed in paragraphs 606-10-25-36 to 25-37;
b. result in a reassessment of whether performance bonuses or penalties in the contract may occur, which would affect the transaction price; and
c. suggest that the contractor should evaluate the need to recognize a provision for anticipated losses on the contract under paragraphs 605-35-25-45 to 25-49, which largely have been retained from current guidance.

D30. What discount rate does an entity use when determining the time value of money to include in the transaction price for a property management service contract that is prepaid as part of an all-cash operating property sale?

This question assumes that the property sale and the property management service contract[7] are two performance obligations.

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price the customer would have paid if it had paid cash for the promised goods or services when or as they transfer. Therefore, a seller determines the discount rate by identifying the rate that would discount the stand-alone selling price (and related timing) of the property management services to the allocated transaction price. [606-10-32-15, 32-20]

The discount rate should be the rate that would exist in a separate financing transaction between the buyer and the seller at contract inception that reflects the credit characteristics of the party receiving financing in the contract (the seller), as well as any collateral or security provided by the buyer or the seller, including assets transferred in the contract.

The seller adjusts the transaction price to reflect the time value of money only if the financing component is significant to the *contract*, not necessarily significant to one or more of the separate performance obligations. In this case, the seller would evaluate the significance of the financing component associated with the prepayment of the property management services relative to the transaction price of the contract (i.e. the transaction price for the sale of the property and property management services combined).

[7] The property management services are determined to be a single performance obligation because the entity is providing a series of distinct services that are substantially the same with the same pattern of transfer (606-10-25-14(b)). See additional discussion in Question C30.

A contract does not have a significant financing component even if the timing of payments and the transfer of control of the goods or services differs significantly if one of these factors exist:

— the customer makes an advance payment, and the timing of the transfer of goods or services is at the customer's discretion;

— a substantial amount of the consideration is contingent on a future event outside the parties' control; or

— the difference between the promised consideration and the cash-selling price arises for reasons other than financing.

As a practical expedient, a seller does not need to account for a financing component when the period is expected to be one year or less between when the seller transfers a good or service and when the customer pays for the good or service. [606-10-32-17 – 32-18]

The guidance on determining the transaction price applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

Paragraph 360-20-40-43(d) addresses the accounting when a seller agrees to manage the property for the buyer after the property is sold without compensation or receives compensation that is less than prevailing rates. When the seller recognizes the sale, it must impute the compensation for the services and recognize it in income as it performs the services over the management contract period. Additionally, the seller attributes the remaining sales price (i.e. the residual) to the sale.

While the seller also recognizes the property management fee revenue over the service period under Topic 606:

a. the imputed value (which represents the present value of the market rate of the services) likely will differ from the allocated transaction price (based on relative stand-alone selling prices); and

b. the seller must gross-up the revenue amount and recognize interest expense if the financing component associated with the prepayment of the management services is significant to the contract. See Question E10 for further discussion. [606-10-32-29]

Example D30: Sale of property with prepaid property management services

Description of the arrangement

ABC Corp. sells an office building with a carrying amount of $1,500,000 to a customer and agrees to manage the office building for three years. The buyer pays $2,000,000 in cash at the date of sale for the office building and the management services. ABC identifies two performance obligations and allocates $1,714,286 of the transaction price to the sale of the office building and $285,714 to the future property management services (see Example E10 for illustration).

ABC makes these allocations based on the stand-alone selling prices of $1,800,000 for the office building without the services and $100,000 per year for the property management services. ABC determines that the financing component is significant to the contract,[8] and that the property management services will be delivered ratably over the three-year service period.

Evaluation

Because ABC has determined that the financing component is significant to the contract, it establishes an initial contract liability of $285,714 and accrues interest expense each period on the principal balance. ABC calculates the interest rate by determining what rate discounts the cash selling price of the property management services ($300,000 or $100,000 per year for 3 years of monthly payments) to the promised consideration (i.e. $285,714).

The interest rate implicit in the contract is 3.19%. This rate (and the resulting interest expense amounts below) assume monthly payments on the contract liability equal to $8,333.33 ($300,000 over 36 months) to reflect the property management services being delivered over time.

One way to account for this would be as follows:

At inception:

	Debit	Credit
Cash	285,714[(1)]	
Contract liability		285,714
To reflect the cash received that is allocated to the property management services		
Cash	1,714,286[(2)]	
Cost of sales	1,500,000	
Property and equipment		1,500,000
Revenue		1,714,286
To record revenue and cost of sales on the sale of the office building (note that revenue and cost of sales would be reported net as a gain if the sale is to a noncustomer)		

Notes:

(1) + (2) = $2,000,000 cash consideration received from buyer

[8] ABC adjusts the transaction price for the time value of money only if the financing component is significant to the contract. This illustration also assumes the rate implicit in the contract is reasonable relative to what ABC's borrowing rate would be in a separate financing transaction.

Year 1:

	Debit	Credit
Interest expense	7,783	
Contract Liability		7,783
To accrue the aggregate annual interest expense (based on the hypothetical monthly payments) on the contract liability		
Contract liability	100,000	
Revenue		100,000
To recognize the year one property management service revenue		

Year 2:

	Debit	Credit
Interest expense	4,794	
Contract Liability		4,794
To accrue the aggregate annual interest expense (based on the hypothetical monthly payments) on the contract liability		
Contract liability	100,000	
Revenue		100,000
To recognize the year two property management service revenue		

Year 3:

	Debit	Credit
Interest expense	1,709	
Contract Liability		1,709
To accrue the aggregate annual interest expense (based on the hypothetical monthly payments) on the contract liability		
Contract liability	100,000	
Revenue		100,000
To recognize the year three property management service revenue		

D40. In an exchange of real estate, does the transferor of the real estate apply the guidance for nonmonetary transactions or the guidance on noncash consideration?

Topic 606 supersedes most of the real estate-specific exchange guidance in Topic 845. The scope of Topic 845 also was amended to exclude transactions within the scope of Topic 606 (i.e. transactions with customers) regardless of the form of the consideration received, as well as most transactions within the scope of Subtopic 610-20 (i.e. sales or transfers of nonfinancial assets to noncustomers). What remains in the scope of Topic 845 (paragraphs 845-10-15-19 and 15-20) are transactions where the noncash consideration received in exchange for a nonfinancial asset to a noncustomer is a noncontrolling ownership interest in the buyer of the nonfinancial asset unless the transaction is (see additional discussion below):

a. a capital contribution of real estate in return for an unconsolidated real estate investment that is in the scope of Subtopic 970-323, *Real Estate-General – Investments – Equity Method and Joint Ventures;* or

b. a transfer of a subsidiary or a group of assets that constitutes a business (see paragraph 845-10-30-25) that is in the scope of Subtopic 810-10.

Topic 845 also still applies to nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers (e.g. exchanges of similar land lots between real estate developers) because paragraph 606-10-15-2(e) scopes those transactions out of Topic 606.

See additional discussion of proposed changes to this guidance in the section *Proposed Clarifications to the Scope of Asset Derecognition Guidance*.

Nonmonetary Transactions in the Scope of Topic 606 (transfers with customers) or Subtopic 610-20 (transfers of nonfinancial assets involving the receipt of nonmonetary consideration *other than* a noncontrolling interest in the buyer/transferee)

For transactions accounted for under Topic 606 or Subtopic 610-20, the seller/transferor will need to determine whether the transaction has commercial substance when it evaluates whether a contract exists (Step 1). When a contract exists, because it meets the criteria in paragraph 606-10-25-1, the seller/transferor measures the noncash consideration at fair value (or the stand-alone selling price of the promised goods or services if it cannot make a reasonable estimate of the fair value). See Question B10 for discussion about the accounting when a contract does not exist.

Paragraph 606-10-32-21 specifies the measurement date for noncash consideration is at contract inception (i.e. the date at which a contract exists). Paragraph 606-10-32-23 also states that changes in the fair value of the consideration after contract inception are:

— not included in the transaction price if they are due to the form of the consideration (e.g. changes in the share price of securities or changes in the fair value of land which the entity is entitled to receive from a customer); or

— variable consideration if they are caused by something other than the form of the consideration (e.g. the exercise price of a share option changes because of the entity's performance).

If the changes in the fair value of the consideration are due to both the form of the consideration and some reason other than the form of the consideration, then the seller applies the variable consideration guidance only to the variability resulting from reasons other than the form of the consideration.

Nonmonetary transactions involving the receipt of a noncontrolling interest in the buyer (noncustomer)

For noncustomer transactions involving the transfer of a nonfinancial asset in exchange for a noncontrolling interest in the buyer, the seller/transferor first evaluates whether the transaction is a contribution of real estate in exchange for an unconsolidated real estate investment within the scope of Subtopic 970-323. If it is, the guidance in that Subtopic applies (see paragraph 845-10-15-20(b)). An investor contributing real estate to a venture records its investment at the cost of the contributed real estate (with no profit recognized) regardless of what other investors may contribute because the transaction is a contribution of capital. In some cases, however, these transactions may be in substance sales; see Question F90 for additional discussion on applying Subtopic 970-323. [970-323-30-3]

If the transaction is not a contribution of real estate in exchange for an unconsolidated real estate investment within the scope of Subtopic 970-323, then the seller/transferor evaluates if the transaction is a transfer of a subsidiary or a group of assets that constitutes a business (see paragraph 845-10-30-25). If so, the seller accounts for the transfer under Subtopic 810-10. This accounting requires that the transaction be measured at fair value with recognition of gain or loss in income if the seller/transferor no longer controls the subsidiary or group of assets or in equity attributable to the seller/transferor if the seller/transferor retains control of the subsidiary or group of assets. [810-10-40-5, 45-23]

Proposed changes to noncustomer nonmonetary exchange guidance

The FASB has proposed changes to this guidance that would require that all transactions in which an entity sells/transfers a nonfinancial asset (or an in-substance nonfinancial asset) to a noncustomer in exchange for a noncontrolling ownership interest be accounted for under Subtopic 610-20.

This includes:

a. exchanges where the noncontrolling interest received (or retained) is a noncontrolling ownership interest in the post-sale owner of the property;
b. transfers to an existing equity method investee; and
c. contributions of nonfinancial assets to form joint ventures, including real estate joint ventures.

Under the proposal, when a noncontrolling interest in the buyer/transferee is received/retained, it is considered noncash consideration (see paragraph 606-10-32-21) and its fair value at contract inception is included in the transaction price. The carrying amount of liabilities assumed by the buyer/transferee (subject to the constraint on estimating variable consideration in paragraph 606-10-32-11) also would be included in the consideration received for computing the gain or loss. The proposal would eliminate the guidance in Topic 845 on the transfer of a nonfinancial asset for a noncontrolling interest in the buyer.

For information about the proposed definition of in-substance nonfinancial asset, see Question A20 and Question F90.

Comparison to legacy US GAAP

Paragraph 845-10-15-4(e) excludes from the scope of Topic 845 transactions that involve a nonmonetary exchange in which the transferor of an asset receives an equity interest in the transferee, except in certain exchanges of a nonfinancial asset for a noncontrolling ownership interest. The guidance in the subsection of Topic 845 on exchanges of a nonfinancial asset for a noncontrolling ownership interest does not apply to:

- transfers between a joint venture and its owners;
- capital contributions of real estate in return for an unconsolidated real estate investment;
- transfers of real estate in exchange for nonmonetary assets other than real estate; and
- the deconsolidation (or derecognition) of a subsidiary (or group of assets) that constitutes a business that is in the scope of Subtopic 810-10 (see paragraph 845-10-15-20).

Under current US GAAP, most nonmonetary transactions where the transferor receives an ownership interest in the transferee in exchange for real estate are outside the scope of Topic 845, and the nature of the inbound asset determines how the exchange will be accounted for:

- If the inbound asset is a controlling financial interest in the transferee and the transferee is a business, Topic 805, Business Combinations, applies (and the gain on the outbound real estate is deferred).
- If the inbound asset is an equity interest in the buyer but the transferee is not a business, Subtopic 970-323 applies (unless the asset received is an equity security with a readily determinable fair value accounted for under Topic 320, *Investments–Debt and Equity Securities;* in those cases, we believe the transaction is monetary and accounted for under Subtopic 360-20).

As discussed above, Subtopic 970-323 requires that the investor contributing real estate to a venture record its investment in the venture at the cost of the contributed real estate (with no profit recognition) regardless of what other investors may contribute because the transaction is a contribution of capital (unless the transaction is in-substance a sale).

When the transferor does not receive an equity interest in the transferee (including when the transferor receives an equity interest in a real estate entity other than the transferee), the transaction generally is measured at fair value. When the inbound interest is a controlling financial interest in a business (as defined by Section 805-10-20), the transaction is accounted for as a business combination under Topic 805. Topic 805 requires the inbound asset to be measured at fair value and the timing of profit recognition on the transfer of the outbound real estate is accounted for under Subtopic 360-20.

When the transferor does not receive an equity interest in the transferee and the inbound asset is not a controlling financial interest in a business, the transferor needs to evaluate whether the inbound asset is real estate (including in-substance real estate). If the inbound asset is not real estate, Topic 845 governs the measurement of the exchange, but profit recognition would be evaluated under Subtopic 360-20 (or Subtopic 976-605). If the inbound asset is real estate and the transaction qualifies as an exchange as defined under Topic 845, then that guidance applies[9] to both recognition and measurement. If the inbound asset is a financial asset, like cash or an equity security with a readily determinable fair value that is accounted for under Topic 320, we believe it would make the transaction monetary and subject to Subtopic 360-20.

[9] While paragraph 360-20-15-10(c) states that the guidance in Subtopic 360-20 does not apply to real estate for real estate exchanges, we believe that if the exchange would not result in profit recognition under Subtopic 360-20 (or Subtopic 976-605), it raises the question of whether the conclusion on fair value measurement under Topic 845 is appropriate.

E Step 4: Allocate the transaction price

E10. How does the seller allocate the transaction price in a contract that transfers control of a property and also requires the seller to provide ongoing property management services to a customer? What if the buyer is not a customer?

When the sale of the property and the property management services[10] are separate performance obligations, the seller generally allocates the transaction price based on relative stand-alone selling prices (i.e. the price at which an entity would sell a promised good or service separately to a customer). However, in some cases the seller attributes variable consideration and discounts to some, but not all, performance obligations or distinct goods and services within a series of distinct goods or services that comprise a single performance obligation under paragraph 606-10-25-14(b). [606-10-25-15]

The seller should first consider the guidance on allocating variable consideration. If the contract includes consideration that is variable, the seller will need to determine if the variable consideration should be allocated to one or both performance obligations. The seller must allocate variable consideration (and subsequent changes to that amount) entirely to a single performance obligation (or to distinct goods or services within a series of distinct goods or services that are accounted for as a single performance obligation) if the:

a. terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or the distinct good or service within the series, and
b. allocation of the variable amount entirely to the performance obligation or the distinct good or service within the series is consistent with the objective to allocate the transaction price in an amount that depicts the consideration that the entity expects to be entitled to in exchange for the promised goods or services after considering the contract's performance obligations and payment terms. [606-10-32-28, 32-40]

It is not uncommon for stand-alone property management service contracts to include a base fee and a variable fee that may depend on the property's operations. A real estate sale with an accompanying property management services contract also may include variable consideration. The seller/property manager needs to consider the guidance in paragraph 606-10-32-40 when concluding whether it should allocate the variable component entirely to the property management services or to both the property management services and the property sale.

If the seller allocates the variable consideration entirely to the property management services, it will need to determine if those services constitute a series of distinct time increments of property management services. If the seller concludes the property management services are

[10] See Question C30 on accounting for a series of distinct, daily property management services as a single performance obligation.

a series of distinct services (i.e. a series of daily, weekly, monthly management services), it must further allocate the variable consideration to the distinct service periods within the single, series performance obligation if the:

a. variable consideration earned for a given distinct service period relates specifically to the seller's services for that period (or an outcome from those services), and

b. allocation of that amount specifically to the distinct service period is consistent with the allocation objective in paragraph 606-10-32-40(b).

The seller follows these steps in allocating the variable consideration:

— First, the seller must determine whether the nature of the property management services is to provide a single, integrated service offering for a defined period of time, or to perform a specified set of activities during the period. Important to this determination is whether the activities the seller will perform to fulfill the performance obligation are indeterminate (e.g. even if the type of activities are generally understood, the quantity and mix of activities that will need to be performed to fulfill the obligation are unknown), or are known upfront (e.g. the seller will do X, Y and Z once each week for three years).

— Second, the seller must determine whether the contractual service period can be subdivided into smaller time increments during which the seller's activities are substantially the same in each time increment. For example, could a three-year property management services contract be subdivided into time periods like three annual periods or 36 monthly periods?

— Third, the seller must conclude that those determined time increments of service are distinct from each other under paragraphs 606-10-25-19 and 606-10-25-21. If they are not distinct, then the series provision cannot apply to the property management services performance obligation.

— Lastly, if there is a series of distinct service periods within the single property management services performance obligation, the seller must determine whether allocating the variable fees earned during each distinct service period only to that service period is consistent with the allocation objective in paragraph 606-10-32-40.

If the seller must allocate the variable consideration entirely to the property management services performance obligation, *and* that performance obligation is a series of distinct service periods to which the variable consideration earned each period can be allocated, the seller will not need to estimate the total variable fees that will be earned during the performance obligation period. The variable fees earned each period will be allocated to, and recognized in, each period.

If the seller (a) cannot allocate the variable consideration entirely to the property management services performance obligation, (b) the obligation is not a series of distinct service periods, or (c) the variable consideration earned each distinct service period within a series cannot be allocated to that distinct service period, the seller generally will need to estimate the total transaction price associated with that performance obligation (including the variable consideration) to which the seller expects to be entitled for performing the property management services over the full performance obligation service period subject to the constraint. The constraint limits the seller to only including estimates of variable consideration in the transaction price to the extent that it is probable that a significant reversal in the cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. See additional discussion about the constraint in Question D10. [606-10-32-11 – 32-14]

The seller will recognize the transaction price (which may include fixed and variable consideration) allocated to the property management services over time based on an appropriate measure of progress as the performance obligation is satisfied. For additional discussion about recognizing property management service revenue, see Question F130.

If the sale and accompanying property management services contract also include a future profits interest (see Question D10), the seller would perform a similar analysis because of the variable consideration and existence of more than one performance obligation.

After the seller allocates variable consideration, it will need to determine if any discount should be allocated entirely to one of the performance obligations or allocated proportionately. The discount is the difference between the transaction price and the sum of the stand-alone selling prices. The guidance on the allocation of variable consideration discussed above differs from the guidance on the allocation of a discount to some, but not all, performance obligations or to distinct goods or services within a series of distinct goods or services that are accounted for as a single performance obligation. An entity should allocate a discount entirely to one or more, but not all, of the performance obligations if all of the following conditions exist:

— the entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

— the entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and

— the discount attributable to each bundle of goods or services described is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation to which the discount in the contract belongs. [606-10-32-37]

In our experience, most real estate companies do not offer a wide range of bundled goods or services. Therefore, in most cases, these conditions will not exist, and the seller will allocate the discount to all performance obligations in the contract on a relative stand-alone selling price basis. See Example E10.

We believe the guidance on allocating the transaction price for customer transactions also applies by analogy to noncustomer transactions even though Subtopic 610-20 currently does not address transactions with a noncustomer with more than one performance obligation. The proposed ASU, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, clarifies that a seller would apply the revenue guidance on identifying distinct goods and services and allocating consideration to them for noncustomer sales of nonfinancial assets or in-substance nonfinancial assets. The proposal also would require that the seller separately account for parts of a contract that are not assets of the entity to be derecognized, for example, guarantees or ongoing service contracts. See additional discussion of this project in Question A20.

Comparison to legacy US GAAP

Paragraph 360-20-40-43(d) addresses the accounting when a seller agrees to manage the property for the buyer after the property is sold without compensation or receives compensation that is less than prevailing rates. When the seller recognizes the sale, it must impute the compensation for the services and recognize it in income as it performs the services over the management contract period. Additionally, the seller attributes the remaining sales price (i.e. the residual) to the sale.

While the seller also recognizes the property management fee revenue over the service period under Topic 606:

a. the imputed value (which represents the present value of the market rate of the services) likely will differ from the allocated transaction price (based on relative stand-alone selling prices); and
b. the seller must gross up the revenue amount and recognize interest expense, if the financing component associated with the prepayment of the management services is significant to the contract. [606-10-32-29]

Example E10: Sale of property with ongoing property management services

Description of the arrangement

ABC Corp. sells an office building with a carrying amount of $1,500,000 to a customer and agrees to manage the office building for three years for total consideration of $2,000,000 payable in cash upon closing of the sale. The estimated stand-alone selling price of the office building and the series of management services are $1,800,000 and $100,000 per year, respectively. Assume that:

a. the customer makes no ongoing payments for the services;
b. the financing component is not significant to the contract;[11] and
c. the criteria for allocating the overall discount entirely to one of the performance obligations are not met. [606-10-32-37]

Evaluation

The seller allocates the total transaction price of $2,000,000 to the two separate performance obligations[12] based on relative stand-alone selling prices.

Combined stand-alone selling price: $2,100,000 $1,800,000 (property stand-alone selling price) + $300,000 (property management services stand-alone selling price at $100,000 each year for 3 years)
Transaction price allocated to property sale: $1,714,286 ($1,800,000 ÷ $2,100,000) × $2,000,000
Transaction price allocated to property management services: $285,714 ($300,000 ÷ $2,100,000) × $2,000,000
Profit – recognized when control of the property is transferred: $214,286 $1,714,286 – $1,500,000
Property management service fee revenue – recognized over the three-year service period as the performance obligation is satisfied: $285,714

[11] See Example D20 for an illustration of the accounting if the financing component is significant to the contract.

[12] The property management services are determined to be a single performance obligation because the entity is providing a series of distinct services that are substantially the same with the same pattern of transfer (606-10-25-14(b)). See further discussion in Question C30.

If the arrangement also included ongoing payments of $10,000 per year for the property management services, the process for allocating the total transaction price of $2,030,000 ($2,000,000 payable at closing + $30,000 in ongoing payments of $10,000 per year for three years) would follow the same approach as illustrated above. This approach also assumes that the financing component is not significant to the contract and the discount is not allocated entirely to one of the performance obligations.

The seller would allocate the total transaction price of $2,030,000 to the two separate performance obligations based on relative stand-alone selling prices:

Combined stand-alone selling price: $2,100,000 $1,800,000 (property stand-alone selling price) + $300,000 (property management services stand-alone selling price of $100,000 each year for 3 years)
Transaction price allocated to property sale: $1,740,000 ($1,800,000 ÷ $2,100,000) × $2,030,000
Transaction price allocated to property management services: $290,000 ($300,000 ÷ $2,100,000) × $2,030,000
Profit – recognized when control of the property is transferred: $240,000 $1,740,000 – $1,500,000
Property management service fee revenue – recognized over the three-year service period as the performance obligation is satisfied: $290,000

F Step 5: Recognize revenue

F10. At what point does control typically transfer in a real estate sale when the performance obligation is only the property that is transferred?

An entity recognizes revenue when it satisfies a performance obligation by transferring control of the good or service to the customer. An asset is considered transferred when, or as, the customer obtains control of the asset, which gives the customer the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. An entity must determine at contract inception whether it satisfies the performance obligation over time or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A performance obligation to deliver a single asset (or group of assets) on a single settlement date is typically satisfied at a point in time because it does not meet any of the over-time control transfer criteria and there is no progress to measure. [606-10-25-23 – 25-24, 25-27]

For performance obligations satisfied at a point in time, these indicators suggest that control has transferred:

— the entity has a present right to payment for the asset;

— the customer has legal title to the asset;

— the entity has transferred physical possession of the asset;

— the customer has the significant risks and rewards of ownership of the asset; and

— the customer has accepted the asset. [606-10-25-30]

We believe in the context of US property sales that the guidance generally suggests that control transfers at closing because the closing date is the point in time when most of the indicators typically are met. The Board reached a view consistent with this when it addressed the issue of control transfer in real estate transactions within the scope of ASU 2011-10, *Derecognition of in Substance Real Estate*:

FASB excerpt: ASU 2011-10

BC10. Therefore, an entity would look to the definition and indicators of control in the proposed revenue recognition guidance to determine when the counterparty to the transaction obtains control of the asset (that is, real estate) and when to derecognize the real estate. Under the proposed revenue recognition guidance, indicators that the customer has obtained control of a good or service include, among others, the fact that the customer has legal title and physical possession.

While transfer of control for sales of existing property often occurs at closing, the seller needs to consider the facts and circumstances of the particular transaction. For example, as discussed in Question B10, paragraphs 606-10-55-95 to 55-98 illustrate a situation where a real estate developer sells a building and provides long-term, nonrecourse financing for 95 percent of the sales price. The buyer expects to repay the loan primarily from income derived from its restaurant business. This business faces significant risks because of the high competition in the industry, and the buyer lacks other income or assets that it could use to repay the loan and lacks industry experience.

The seller may conclude that although it has transferred legal title and physical possession of the building to the buyer at closing, it has retained control of the building based on its analysis of the control indicators in paragraph 606-10-25-30.

Question F50 and Question F70 address other situations where control may not reside with the party with legal title and physical possession.

The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

FASB excerpt: 360-20

40-7 A sale shall not be considered consummated until all of the following conditions are met:

a. The parties are bound by the terms of a contract.

b. All consideration has been exchanged.

c. Any permanent financing for which the seller is responsible has been arranged.

d. All conditions precedent to closing have been performed. Paragraph 360-20-40-28 provides an exception to this requirement if the seller is constructing office buildings, condominiums, shopping centers, or similar structures.

Usually, a sale meets those four conditions at closing or after the closing, and not when an agreement to sell is signed or at a pre-closing. We believe the conditions required to support consummation of a sale under Subtopic 360-20 are similar to the indicators of the point in time when control transfers under Topic 606.

However, Subtopic 360-20 prevents derecognition in certain circumstances even when a sale is consummated. Even if a sale has been consummated, the initial and continuing investment requirements may not be met or certain types of continuing involvement may be present suggesting that the risks and rewards of ownership have not transferred. In those situations, the seller may be unable to derecognize the property or recognize full profit on the sale.

In contrast, Topic 606 requires revenue recognition (and therefore derecognition) at the point in time control transfers, which is based on indicators and not criteria as long as a contract exists. Consequently, derecognition and revenue/profit recognition under Topic 606/Subtopic 610-20 may occur earlier than under Subtopic 360-20.

Topic 606 does not provide an exception for a seller constructing office buildings, condominiums, shopping centers or similar structures (like paragraph 360-20-40-7(d) above). See Question F40 for additional discussion of when control of a condominium unit (or similar structure) transfers under Topic 606.

F20. When does control typically transfer in a real estate construction contract (e.g. for the development of property improvements such as a building) when the contract represents a single performance obligation for the construction services?

An entity recognizes revenue when it satisfies a performance obligation by transferring control of the good or service to the customer. An entity considers an asset or service transferred when, or as, the customer obtains control of the asset. An entity determines at contract inception whether it satisfies the performance obligation over time or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. [606-10-25-23 – 25-24]

An entity transfers control of a good or service over time if the transaction meets at least one of the following criteria: [606-10-25-27]

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

This criterion primarily applies to traditional service contracts (e.g. property management services) when the customer is benefitting on a periodic basis as the entity performs (e.g. as the property is being managed) as opposed to service contracts when an asset is being constructed or enhanced on the customer's behalf. When a customer's asset is being constructed or enhanced, further analysis is necessary under criterion (b), and criterion (c) if criterion (b) is not met.

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

We believe this criterion generally will be met in a real estate construction contract when the customer owns the underlying land and takes control of the property improvements as construction progresses. In that case, the customer generally is able to direct the use of, and obtain substantially all of the remaining benefits from, those improvements during construction.

The customer generally is able to use the property improvements to enhance the value of other assets during the construction period. The ability to use the property improvements includes selling the land the customer owns on which the improvements are built; selling or exchanging the property, including the partially completed improvements; and pledging the property with the partially completed improvements to secure a loan.

This analysis applies when the customer controls and holds legal title to the land on which improvements are constructed. A similar analysis also may apply if the customer leases the underlying land on a long–term basis and will own the property improvements. A developer will not meet criterion (b) however, if it (as opposed to the customer) controls the property and/or the improvements until construction is complete. This may occur in constructing condominium units (or similar structures). See Question F40 for additional discussion.

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.

An entity only needs to meet one criterion in paragraph 606-10-25-27 to conclude that a performance obligation is satisfied over time. We believe this criterion may also be met in a real estate construction contract if the customer owns the underlying land and takes control of the property improvements as construction progresses because the developer's performance generally does not create an asset with alternative use to the developer. Usually the customer controls the property improvements being constructed and those improvements are affixed to land controlled by the customer. Therefore, the developer likely is legally and practically prohibited from directing the improvements for any other use. [606-10-25-27 – 25-28]

However, to meet this criterion, the developer also must have an enforceable right to payment for performance completed to date, which often is the case when a contract includes payment provisions that protect the developer in the event of a termination for convenience by the customer.

If the entity meets at least one of the criteria in paragraph 606-10-25-27, revenue on the construction services performance obligation is recognized over time as satisfaction of the performance obligation progresses.

The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

Contractors currently apply either the percentage-of-completion method or the completed-contract method under paragraph 605-35-25-1. A contractor can use Subtopic 605-35's percentage-of-completion method if it has the ability to make reliable estimates of the progress toward completion. Typically a contractor can estimate contract revenues and costs, and in those circumstances percentage-of-completion is the preferable method. [605-35-25-57]

The percentage-of-completion method recognizes income as work on a contract progresses.

Method A	Method B
Multiply the total estimated contract revenue by the percentage of completion (based on an input or output measure) and *subtract* from it the revenue recognized in prior periods.	*Multiply* the total estimated gross profit by the percentage-of-completion, and *subtract* from it the gross profit recognized in prior periods. *Add* that periodic gross profit to the costs incurred during the period to arrive at revenue for the period.

If an entity is using the cost-to-cost method for measuring progress, it generally will arrive at substantially the same periodic revenue recognition under either approach.

Topic 606 does not allow an entity to elect an accounting policy for its pattern of revenue recognition. An entity recognizes revenue over time for performance obligations meeting one of the criteria in paragraph 606-10-25-27 using the pattern that best depicts the entity's satisfaction of its performance obligation.

If a contractor had historically been accounting for those contracts under the completed-contract method, the change to Topic 606's over-time revenue recognition will be significant. If the contractor had been using the percentage-of-completion method, the effect of transitioning to Topic 606's pattern of revenue recognition will, in part, depend on whether it meets the over-time criteria; how it measures its progress; and whether it currently uses Method A or Method B. (Method B is not permissible under Topic 606.)

A contractor using the cost-to-cost method to measure progress under Topic 606 may arrive at a similar revenue and gross profit recognition pattern for its contracts satisfied over time if it had historically used a cost-to-cost measure. However, a contractor using a measure other than cost-to-cost, or historically using Method B, may not arrive at a similar revenue and gross profit recognition because Topics 606 and 340 de-link the accounting for contract revenue and contract costs so the profit margin may not be constant.

F30. When does control typically transfer in a contract with a customer that includes a property sale and an accompanying construction contract (e.g. for the development of property improvements for the customer, such as a building on the land)?

As discussed in Question C20, a seller/developer first needs to determine whether the contract contains one or two performance obligations.

In the more common scenario when the property sale and the construction services are two performance obligations, the seller/developer usually allocates the transaction price to those two performance obligations based on relative stand-alone selling prices (see Question E10). The seller/developer evaluates each performance obligation to determine whether it recognizes revenue over time or at a point in time. As discussed in Question F10, control of property often transfers at a point in time, and as discussed in Question F20, construction services (as a stand-alone performance obligation) are often, but not always, satisfied over time.

In the less common scenario when the property sale and the construction contract comprise a single performance obligation, the entity will need to analyze whether the single performance obligation is satisfied:

— at a point in time – upon delivery of the completed property, including improvements, or

— over time – as title to the land transfers and construction progresses on the improvements affixed to the customer-owned land.

If title to the land transfers to the customer before construction begins, and the customer owns the improvements during construction, we believe the analysis of the over-time criteria relative to the single combined performance obligation may be similar to the analysis in Question F20. This analysis shows that the contract will often meet the criterion in paragraph 606-10-25-27(b) because the seller/developer's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

When there is just one performance obligation for both the land sale and the construction services, however, the total revenue recognized over time represents the total transaction price (including the contract consideration for both elements). Progress toward satisfaction of that single performance obligation is measured relative to both elements (see Example F30).

When there is a single performance obligation and the customer does not hold title to the land or have legal ownership of the improvements affixed to the land as construction progresses (e.g. in some contracts to construct condominium units or similar structures), it may be difficult to conclude the performance obligation is satisfied over time. See additional discussion in Question F40.

The guidance on control transfer applies to both customer and noncustomer transactions.

Example F30: Sale of land with construction contract

Description of the arrangement

ABC Corp. sells land with a carrying amount of $400,000 to DEF Corp. for $1,000,000. Additionally, ABC agrees to build a fitness center for an additional $500,000 (estimated cost of $400,000). Assume the sale of the land and the construction of the fitness center comprise two separate performance obligations (see additional discussion in Question C20) and DEF obtains the title to the land at closing (before construction of the fitness center begins). ABC allocates $950,000 (of the total $1,500,000 transaction price) to the sale of the land and $550,000 to the construction contract, based on their relative stand-alone selling prices.

Evaluation

Because the sale of the land and construction of the fitness center comprise two separate performance obligations, ABC will need to determine when, or over what period, it satisfies each of the performance obligations. ABC concludes that control of the land transfers at a point in time (when DEF takes legal and physical possession of the land) and control of the fitness center on DEF's land transfers over time because ABC is creating and enhancing an asset that DEF controls as it is created or enhanced.

For the land sale, ABC recognizes $550,000 in profit (allocated transaction price of $950,000 less the $400,000 carrying amount) at closing.

For the construction services, ABC uses an input method to recognize revenue based on its periodic efforts relative to the total expected effort to completely satisfy the performance obligation.

Assume at the end of period one that the accumulated costs for constructing the fitness center are $200,000. Using costs incurred to measure its progress, ABC recognizes $275,000 of revenue ($550,000 x ($200,000 ÷ $400,000)) in period one. ABC recognizes the remaining revenue of $275,000 over time as it constructs the fitness center.

F40. Can the seller/developer of a condominium unit (or similar structure) recognize revenue over time as construction of the unit progresses if title to the completed unit does not transfer until construction is completed?

To recognize revenue over time, the transaction must meet at least one of the following criteria in paragraph 606-10-25-27:

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

As discussed in Question F20, this criterion primarily applies to traditional service contracts (e.g. property management services) when the customer benefits on a periodic basis as the entity performs (e.g. as the property is being managed) in contrast to service contracts when an asset is being constructed or enhanced on the customer's behalf. When an asset is being constructed or enhanced on a customer's behalf, further analysis is necessary under criterion (b), or under criterion (c) if criterion (b) is not met.

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

In many cases, we believe the buyer of a condominium unit is unable to direct the use of, and obtain substantially all of the remaining benefits from, the unit during construction because title to the real estate typically does not transfer until construction of the unit is complete and the sale closes. When considering the benefits identified in paragraph 606-10-25-25, the buyer does not hold title to the real estate until the sale closes and generally is unable to use the unit to:

— produce goods or provide services;

— enhance the value of other assets, settle liabilities or reduce expenses;

— sell or exchange the unit; or

— pledge the unit to secure a loan.

The buyer also generally does not direct the use of the unit during construction because it does not hold legal title or have physical possession.

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.

Paragraphs 606-140-55-173 through 55-182 illustrate various scenarios when a seller/developer is constructing a unit in a multi-unit residential complex with differing customer payment structures.

Example 1 presumes the customer pays a deposit on entering into the contract, and the remainder of the contract price is payable upon completion of construction when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion, the seller/developer only has a right to the deposit. The seller/developer does not have a right to payment for work completed to date so it does not meet criterion (c). [606-10-55-174 – 55-175]

Example 2 presumes the buyer makes progress payments during construction, and the contract has substantive terms that preclude the seller/developer from directing the unit to another customer. In addition, the contract precludes the buyer from terminating the contract unless the seller/developer does not perform, and if the buyer defaults on its payments, the seller/developer has the right to all of the consideration promised in the contract if it completes the unit. In this fact pattern, the seller/developer concludes that it meets criterion (c) because the:

— unit does not have an alternative use (i.e. the contract precludes the seller/developer from transferring the unit to another customer – see additional discussion below), and

— seller/developer has an enforceable right to payment for performance completed to-date because the customer must pay all of the consideration promised in the contract if the seller/developer completes the unit.

Paragraph 606-10-55-179 indicates the legal practices in the particular jurisdiction are relevant in arriving at this conclusion. This is the case because if the contract terms provide for the right to payment for performance completed to date but the legal practices in the particular jurisdiction do not allow for enforcement of that right, criterion (c) would not be met. [606-10-55-176 – 55-180]

Example 3 presumes the same facts as Example 2 except in the event of the customer's default, the seller/developer can require the customer to perform as required under the contract, or it can cancel the contract and retain the unit under construction and assess a penalty in proportion to the contract price. The seller/developer has the right to payment for performance completed to date because it could enforce that right, even if the seller/developer also could choose to accept the unit under construction and assess a penalty instead. That choice does not affect the assessment as long as the seller/developer's right to require the customer to continue to perform under the contract is enforceable. [606-10-55 –181 – 55-182]

While the examples primarily focus on the right to payment, even if a seller/developer does have the right to payment for performance completed to date (see Examples 2 and 3), it still needs to conclude the unit cannot be directed to another customer either contractually during construction or practically without incurring significant economic loss when it is completed. Paragraph 606-10-55-10 discusses significant economic loss. [606-10-25-28]

We believe in many cases, buyers of condominium units cannot specify major structural changes to the design of the unit and the seller/developer often will be able to practically direct the unit to another buyer after completion. In those cases, a substantive contractual restriction during construction would need to be in place to conclude the seller/developer's performance does not create an asset with an alternative use to the seller/developer. If so, over time revenue recognition would be appropriate (and required) under criterion (c), assuming the seller/developer is entitled to payment for the work performed to date throughout the contract. The seller/developer should consider all facts and circumstances.

If the seller/developer does not meet the criteria in paragraph 606-10-25-27 for satisfying a performance obligation over time, the performance obligation is satisfied at a point in time. Then the seller/developer would recognize revenue on the sale of a unit when control transfers to the customer, generally at closing as discussed in Question F10. In our experience, US condominium sales contracts generally are structured similar to Example 1, which results in point in time revenue recognition when control of the completed unit transfers to the customer at closing.

If the seller/developer has a further obligation to develop an amenity in connection with the sale of the unit, the seller/developer would consider the guidance in Questions C10 and C20 on determining the number of performance obligations in the contract with the customer and Question F30 on the timing of revenue recognition.

See Question A60 for discussion about the unit of account for these sales under Topic 606.

Comparison to legacy US GAAP

If a seller/developer is separately selling individual units in condominium projects, paragraph 360-20-40-50 requires profit to be recognized by the percentage-of-completion method on the sale of individual units if:

- construction is beyond a preliminary stage;
- the buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit;
- sufficient units have already been sold to assure that the entire property will not revert to rental property;
- sale prices are collectible; and
- aggregate sales proceeds and costs can be reasonably estimated.

Topic 606 changes the current guidance in Subtopic 360-20 for accounting for condominium sales. Sellers/developers may have historically applied the percentage-of-completion method by measuring progress on a cost-to-cost basis relative to the project as a whole, and applying that measure of progress to the estimated gross profit (revenue and expense) on an individual unit sale. The unit is considered sold if the above criteria are met, which typically occurs before closing.

Under Topic 606 sellers/developers generally are required to separately account for each contract with an individual customer unless they reasonably expect the effect on the financial statements of using a portfolio (or project) approach will not differ materially from applying the guidance to the individual contracts. As explained previously, we expect that the portfolio approach will not be available for most condominium projects.

Example F40: Sale of a condominium unit

Description of the arrangement

ABC Corp. is developing a condominium building and begins marketing individual units during construction. On January 1, 20X3, ABC enters into sales contracts with two customers to sell each one a unit at a sales price of $300,000 with an estimated cost of $180,000. Each customer provides a 5% down-payment. Construction on the building is 50% complete.

ABC expects the customers to take possession of the units (and settle all remaining consideration) on January 1, 20X4; however, during construction ABC retains control of the building and the improvements. If the customers cancel the contracts, ABC has a right to only the deposit amount.

Evaluation

Because the arrangement does not meet any of the criteria for satisfying a performance obligation over time, ABC recognizes revenue at the point in time control transfers to the customers, generally when the customers take possession of the units on January 1, 20X4.

F50. When does control transfer in a standstill arrangement in which the owner of a real estate entity that is an in-substance nonfinancial asset defaults on nonrecourse debt and loses its controlling financial interest in the entity, but the lender chooses to maintain the legal relationship until the owner can find a buyer?

An owner/borrower must apply Subtopic 610-20 to evaluate derecognition on the loss of a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is an in-substance nonfinancial asset because the subsidiary defaulted on its nonrecourse debt. The deconsolidation guidance in Subtopic 810-10 does not apply to those transactions. [810-10-40-3B]

The owner/borrower considers Topic 606's control indicators to determine when the lender obtains control, which is defined as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the real estate. Because the entity generally would not meet the over-time criteria, an entity would need to determine the point in time the counterparty (the lender) obtains control of the asset. The following are indicators of the point in time that control has transferred to the customer:

- the entity has a present right to payment for the asset;
- the customer has legal title to the asset;
- the entity has transferred physical possession of the asset;
- the customer has the significant risks and rewards of ownership of the asset; and
- the customer has accepted the asset. [606-10-25-30]

While the transfer of legal title and physical possession often are key indicators of control in the context of real estate sale transactions (see Question F10), we believe further analysis is necessary. Paragraph 606-10-25-30(c) states that physical possession may not coincide with control of an asset, for example, in some repurchase or consignment arrangements when the customer has physical possession but the seller has control, and in some bill-and-hold transactions when the seller has physical possession but the customer controls. For a customer (or lender) to have obtained control of a product (or asset) in a bill-and-hold arrangement, the transaction must meet all of the following criteria:

a. The reason for the bill-and-hold arrangement must be substantive (e.g. the customer has requested the arrangement);

b. The product must be identified separately as belonging to the customer;

c. The product currently must be ready for physical transfer to the customer; and

d. The entity cannot have the ability to use the product or to direct it to another customer. [606-10-55-83]

We believe that in many standstill arrangements, the transaction will meet all of the criteria, which leads to the conclusion that the lender would have control even though the borrower maintains physical possession. In consideration of criterion (d), while the borrower continues to operate the property during the standstill period (and therefore uses it), the lender may have the right to receive as debt service payments substantially all of the cash flows arising from the property's operations.

In addition, the borrower generally does not have the ability to sell the property to another party, benefit from changes in the fair value of the property, or otherwise have the power to direct the activities that most significantly affect the property's economic performance (based on the guidance in Subtopic 810-10).

We believe the control analysis during the standstill period also is similar to the analysis performed when there is a repurchase option in place as discussed in paragraphs 606-10-55-66 to 55-71 that indicates that the holder of an option to acquire the asset (the lender) may presently control the asset even though the other party has physical possession.

The FASB has proposed amendments to Subtopic 610-20 to clarify when derecognition is appropriate for in-substance nonfinancial assets, which include the assets in a subsidiary in which substantially all of the fair value is concentrated in nonfinancial assets. Under the proposal, if control of the nonfinancial asset transfers before the associated liability meets the criteria to be derecognized under Topic 405, *Liabilities*, the entity would recognize a contract asset to the extent the carrying amount of the liability is included in the calculation of the gain or loss on derecognition of the asset. See additional discussion of the project in Questions A20 and F90.

Comparison to legacy US GAAP

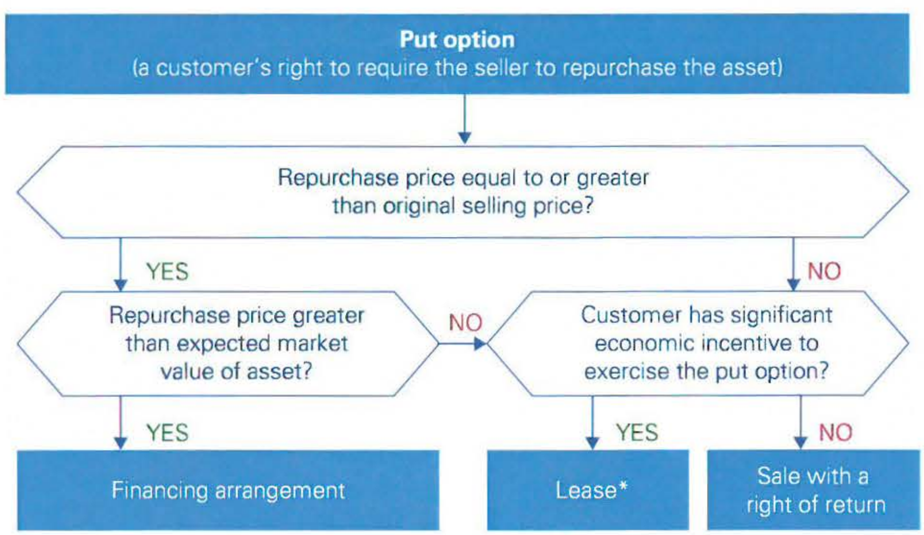
Paragraph 360-20-15-3(f) indicates the loss of a controlling financial interest in a subsidiary that is in-substance real estate because of a default by the subsidiary on its nonrecourse debt is evaluated using the derecognition of real estate guidance instead of the deconsolidation guidance under Subtopic 810-10. Topic 606 retained the scope exemption in the amendments to paragraph 810-10-40-3B for subsidiaries that are in-substance nonfinancial assets. However, rather than those transactions being subject to Subtopic 360-20, they now are subject to Subtopic 610-20.

While these transactions remain subject to the derecognition guidance applicable to transfers of nonfinancial assets and in-substance nonfinancial assets, the application differs from the existing guidance in Subtopic 360-20. Derecognition of the asset occurs under Subtopics 610-20/606-10 when control of the asset transfers, which may occur before derecognition occurs under Subtopic 360-20.

While a difference remains between how the borrower evaluates derecognition (under Subtopics 610-20/606-10) and how the creditor evaluates recognition (under the consolidation guidance in Subtopic 810-10), the concepts are much closer aligned than when the borrower applied Subtopic 360-20 for derecognition.

F60. Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller provides the buyer with an option to put the property back to the seller?

Paragraphs 606-10-55-72 to 55-78 provide guidance on accounting for a seller's obligation to repurchase a property at the buyer's request (a put option). The accounting for these transactions generally depends on the relationships between the repurchase price, the original selling price and the market value of the property.



* If the contract is part of a sale-leaseback transaction, it is accounted for as a financing arrangement.

To determine whether the buyer has a significant economic incentive to exercise its put right, the seller considers the facts and circumstances including the relationship of the repurchase price to the expected market value of the property at the date of the repurchase (including consideration of the time value of money) and the amount of time until the right expires. If the repurchase price is expected to significantly exceed the market value of the property, this may indicate the buyer has a significant economic incentive to exercise the put option.

If the seller accounts for the contract as a financing arrangement under paragraph 606-10-55-70, it continues to recognize the property and also recognizes a financial liability initially equal to the consideration received from the buyer. The seller recognizes amounts paid to the buyer above that amount as interest expense (see paragraphs 606-10-55-70 and 55-71). If the option lapses unexercised, the seller derecognizes the property and the liability and recognizes revenue (or gain).

The guidance on control transfer, including the consequence of buyer put options, applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

Paragraph 360-20-40-38 requires a sale of real estate to be accounted for as a financing, leasing or profit-sharing arrangement when the seller has an obligation to repurchase the property. Topic 606 results in a change for transactions with a put option when either the repurchase price is:

— lower than the original selling price of the property and the buyer does not have a significant economic incentive to exercise its option, or

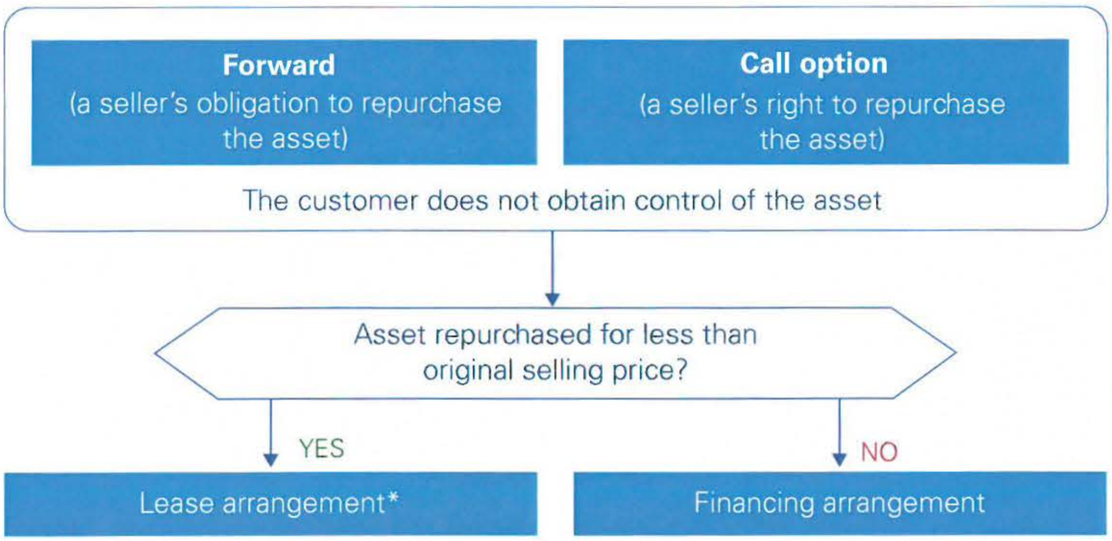
— greater than or equal to the original selling price of the property but less than or equal to the expected market value of the property, and the buyer does not have a significant economic incentive to exercise its option.

In these two circumstances, Topic 606 requires the seller to account for the put option as a right of return, which does not affect revenue recognition unless the seller expects the buyer to return the property.

However, in other circumstances, while Subtopic 360-20 and Topic 606 both may result in lease or financing accounting, there is no option under Topic 606 to apply a profit-sharing model.

F70. Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller obtains the right (or has an obligation) to repurchase the property?

Paragraphs 606-10-55-68 to 55-71 provide guidance on accounting for a seller's right to repurchase a property (a call option) and a seller's obligation to repurchase a property (a forward). A seller's right under a call option (or obligation under a forward agreement) to repurchase the property precludes transfer of control to the buyer because the buyer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the property even though it may have physical possession of the property. Whether the contract is accounted for as a lease or a financing depends on the relationship between the repurchase price and the original selling price.



* If the contract is part of a sale-leaseback transaction, it is accounted for as a financing arrangement.

While an option to repurchase the property at fair value arguably allows the buyer to obtain substantially all of the remaining benefits from the property, it limits the buyer's ability to direct the use of the asset. We believe sales subject to a seller's call option that is exercisable at fair value are accounted for as a leasing or financing arrangement depending on the expectation of the property's fair value over the option period relative to the original selling price. We expect these transactions generally will be accounted for as financing arrangements.

This guidance applies to both conditional and unconditional rights and does not permit or require an assessment of the probability that a conditional right will become unconditional. However, we believe if the condition that makes the right exercisable is controlled by the buyer, then a seller generally considers whether the buyer has the economic incentive to trigger the seller's right to repurchase (similar to the analysis on evaluating buyer put options described in paragraphs 606-10-55-72 to 55-78). An example of when the buyer controls whether the seller can exercise the repurchase right occurs in an anti-speculation clause in which the seller has the right to repurchase the property if the buyer fails to comply with certain provisions of the sales contract.

As discussed in Question F60, if the buyer has an economic incentive not to comply with the contract that triggers the seller's right to repurchase the asset, or there is greater than a remote likelihood the buyer will not comply for other reasons (notwithstanding its ability to comply with the contract), the contract is accounted for as a lease or a financing arrangement. That accounting depends on the relationship between the repurchase price and the original selling price.

If the buyer does not have a significant economic incentive to trigger the seller's right to repurchase the asset, and it is remote that the buyer would trigger the seller's repurchase right for other reasons, the seller follows the guidance on sales with a right of return that prevents recognition of revenue only if the seller expects the buyer to return the property. [606-10-55-22 – 55-29]

Comparison to legacy US GAAP

Paragraph 360-20-40-38 requires a sale of real estate to be accounted for as a financing, leasing or profit-sharing arrangement if the seller has a right to repurchase the property (except for anti-speculation clauses). Topic 606 does not substantially change the accounting for these transactions, except there is no option to apply a profit-sharing model.

Specifically with respect to anti-speculation clauses:

FASB excerpt: 360-20

40-39 Land sale agreements sometimes contain anti-speculation clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Anti-speculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of the sales contract, the seller has the right, but not the obligation, to reacquire the property. The seller's contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. A number of factors might lead one to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. A probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

We believe Topic 606 does not substantially change the accounting for transactions with anti-speculation clauses, if the buyer does not have a significant economic incentive to trigger the seller's repurchase right and it is remote the buyer will trigger the seller's repurchase right for other reasons.

F80. Is a right of first refusal (or a right of first offer) considered an obligation or right to repurchase the property?

We do not believe a right of first refusal based on a bona fide offer by a third party constitutes an obligation or right to repurchase the property because the buyer can act in its best interest and is not economically or contractually compelled to accept the seller's offer. Therefore, the buyer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the property.

We believe a similar conclusion applies to a right of first offer that allows the seller to make an offer to the buyer before the buyer solicits or receives offers from third parties. However, the buyer must be able to act in its best interest and must not be economically or contractually compelled to accept the offer, nor can the seller be economically compelled to make an offer.

The guidance applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

Paragraph 360-20-40-38 (and paragraph 840-40-25-13 in the context of sale-leaseback transactions, that are effective only until Topic 842 becomes effective) indicates a right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. We do not believe there will be any change to the accounting for rights of first refusal or rights of first offer in real estate sale contracts under Topic 606.

F90. How should a seller evaluate transfer of control in the context of a partial sale; for example, on the sale of less than 100 percent of the seller's ownership interest in an entity considered an in-substance nonfinancial asset?

Partial sales of real estate typically occur in the following ways.

Transaction 1. A seller contributes a wholly owned property (or an interest in a real estate entity considered an in-substance nonfinancial asset) to a newly formed venture and simultaneously receives cash from a third party to buy a partial ownership interest in that newly formed venture. The cash may come directly from the third party to the seller, or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a controlling financial interest in the venture post-sale and no interest in the third party.

Transaction 2. Assume the same facts as Transaction 1 except the seller retains only a noncontrolling interest in the venture post-sale.

Transaction 3. A seller contributes a wholly owned property (or an interest in a real estate entity considered an in-substance nonfinancial asset) to a newly formed, wholly owned venture. Sometime later, it sells a partial ownership interest in the venture to a third party for cash. The cash may come directly from the third party to the seller, or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a controlling financial interest in the venture post-sale and no interest in the third party.

Transaction 4. Assume the same facts as Transaction 3 except the seller retains only a noncontrolling interest in the venture post-sale.

Paragraph 970-323-30-3 states an investor contributing real estate to a venture records its investment at the cost of the contributed real estate (with no profit recognized) regardless of what other investors may contribute because the transaction is a contribution of capital. In some cases, however, these transactions may be in-substance sales because the seller withdraws the other investors' contributed cash from the venture to compensate it for the sale of the partial interest, and the seller has no commitment to reinvest the cash.

The seller should look to the revenue recognition guidance to determine if revenue/profit recognition is appropriate (Topic 606 for customer transactions or Subtopic 610-20 for noncustomer transactions). Paragraph 970-323-30-3 includes an example of an in-substance sale when the seller receives cash for a 50 percent interest in the venture and accounts for the transaction as a sale of 50 percent of its interest to the third party. [360-10-40-3A – 40-3C]

There are several views about how to apply the revenue recognition guidance in Transactions 1 through 4.

View A asserts that the control transfer provisions of Topic 606 apply to the partial ownership interest sold without regard to whether the seller retains a controlling financial interest in the venture. Under View A, all the transactions described above (1 through 4) would be accounted for similarly. The initial contribution of the real estate (or in-substance real estate) results in no immediate profit recognition, but when the partial ownership interest is sold for cash (either simultaneously or sometime later), the seller applies Topic 606's control transfer principles relative to the partial ownership interest without regard to whether it retains a controlling financial interest in the venture. When (or as) control of the partial ownership interest is transferred, the seller recognizes profit equal to the transaction price received from the third party (i.e. the buyer of the partial ownership interest) minus the carrying amount of the partial interest sold.

View B, similar to View A, believes that the control transfer provisions of Topic 606 apply to the partial ownership interest sold, but only if the seller no longer retains a controlling financial interest in the venture. Under View B, partial profit (i.e. profit on the partial interest sold) would be recognized for Transactions 2 and 4, similar to View A, but the profit would be deferred until realized through sale or operations of the underlying real estate for Transactions 1 and 3.

View C says that the seller must relinquish its controlling financial interest in the venture under Subtopic 810-10 to recognize profit. Unlike View B though, upon loss of the controlling financial interest in the venture, the seller treats the fair value of its retained interest similar to consideration received and recognizes 100 percent profit at the sale date and the retained interest at fair value (versus only partial profit for the portion sold under View B). Alternatively, if the seller retains a controlling financial interest (sells a noncontrolling interest), no profit is recognized and the difference between the consideration received and the amount by which the noncontrolling interest needs to be adjusted is recorded in additional paid-in capital (versus a deferred profit on the partial interest sold under View B).

View D concludes that the control transfer provisions of Topic 606 apply to the underlying real estate. The seller recognizes no profit unless/until the third-party investor can direct the use of, and obtain substantially all of the remaining benefits of, the underlying property. While the total amount of profit may be the same as the amount recognized under View C, profit recognition may be delayed even beyond deconsolidation of the venture. The delay may occur because the seller could lose its controlling financial interest in the venture (as described in Subtopic 810-10) before the third-party investor could direct the use of, and obtain *substantially all* the remaining benefits from, the property under Topic 606.

View E is a hybrid view that says that Topic 845 applies to Transactions 2 and 4 and Subtopic 810-10 applies to Transactions 1 and 3. As discussed in Question D40, paragraphs 845-10-30-24 to 30-26 require that an exchange involving the receipt of a noncontrolling interest in the buyer (Transactions 2 and 4) be measured at fair value with recognition of full gain (if the retained interest is a cost method investment), or partial gain (if the retained interest is an equity method investment) if these conditions are met:

— fair value is reasonably determinable;

— the transaction is **not** an exchange of products or properties held for sale in the ordinary course of business to facilitate sales to customers; and

— the transaction has commercial substance (i.e. none of the conditions in paragraph 845-10-30-3 are met).

Application of Topic 845 to Transactions 2 and 4 would result in profit recognition similar to Views A and B (assuming the seller accounts for the retained interest under the equity method).

Application of Subtopic 810-10 to Transactions 1 and 3 (similar to View C) would not result in profit recognition, and the difference between the consideration received and the amount by which the noncontrolling interest needs to be adjusted would be recorded in additional paid-in capital because the seller retains its controlling financial interest.

The following table summarizes the results of applying each of the views assuming the seller owns 100 percent of the real estate venture before the transaction and 60 percent after selling 40 percent. The transaction price (equal to the fair value of the 40 percent interest) is $120, and the carrying amount of the seller's 100 percent interest at the time of sale is $100. The seller continues to consolidate the venture post-transaction.

View	Profit recognized in income at sale date	Notes
A	$80 = $120 – ($100 × 40%)	Immediate profit recognition on the partial interest sold
B	$0	No immediate profit recognition because the seller retains a controlling financial interest; gain of $80 is deferred until realized through third-party sale of the property or operations
C	$0	No immediate profit recognition because the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of $80
D	$0	No immediate profit recognition because the buyer does not have control (i.e. substantially all of the remaining benefits) of the underlying property and the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of $80
E	$0	No immediate profit recognition because the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of $80

The following table summarizes the results of applying each of the views assuming the seller owns 100 percent of the real estate venture before the transaction and 40 percent after selling 60 percent. The transaction price, which is equal to the fair value of the 60 percent interest, is \$180, and the carrying amount of the seller's 100 percent interest at the time of sale is \$100.

The seller holds only a noncontrolling interest post-transaction. Assume also that fair value is reasonably determinable, the transaction is **not** an exchange of products or properties held for sale in the ordinary course of business to facilitate sales to customers, and the transaction has commercial substance.

View	Profit recognized in income at sale date	Notes
A	\$120 = \$180 – (\$100 × 60%)	Immediate profit recognition on the partial interest sold; retained interest accounted for under the equity method
B	\$120 = \$180 – (\$100 × 60%)	Immediate profit recognition on the partial interest sold because seller no longer holds a controlling financial interest; retained interest accounted for under the equity method
C	\$200 = (\$180 ÷ 60%)[13] – \$100	Immediate profit recognition based on a sale of the entire 100% interest with the fair value of the 40% retained interest treated as consideration received; retained interest accounted for under the equity method
D	\$0	No immediate profit recognition because the buyer does not have control (i.e. substantially all of the remaining benefits) of the underlying property; seller continues to recognize the property and recognizes a liability for any cash received.
E	\$120 = \$180 – (\$100 × 60%)	Immediate partial profit recognition on the nonmonetary exchange because the seller no longer holds a controlling financial interest and the retained interest is accounted for under the equity method

[13] This calculation results in the implied fair value of a 100% interest. If the fair value of a 60% interest is \$180, the implied fair value of the 100% interest is \$180 ÷ 60%, or \$300.

We believe the accounting for these transactions would be the same regardless of whether the third party is a customer or a noncustomer.

While the views described above reflect possible interpretations of Subtopics 610-20, 810-10 and 970-323 as issued, the FASB is reconsidering this guidance in its project on *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets,* formerly *Clarifying the Definition of a Business Phase 2*[14] (Phase 2).

In its *Clarifying the Definition of a Business (Phase 1)* project, the FASB proposed to change the definition of a business[15], which would result in many more real estate transactions being considered purchases or sales of nonfinancial assets rather than businesses.

In Phase 2, the FASB proposed that Subtopic 610-20 would apply when the property (in the form of a single nonfinancial asset or multiple, distinct in-substance nonfinancial assets) does not meet the definition of a business (and none of the other scope exceptions apply, see additional discussion in Question A20).

An asset would be an *in-substance nonfinancial asset* when (a) it is included either in a group (by contract) or a subsidiary, and (b) substantially all of the fair value (recognized and unrecognized, but excluding cash and cash equivalents) of that group or subsidiary is concentrated in nonfinancial assets (e.g. real estate and intangibles).

When substantially all of the fair value of the group or subsidiary is concentrated in nonfinancial assets, *all* the assets in the group or subsidiary are considered in-substance nonfinancial assets, even if individual assets would be considered financial assets if they were sold independently.

The proposed scope includes transactions in which an entity sells/transfers a nonfinancial asset (or an in-substance nonfinancial asset) in exchange for a noncontrolling ownership interest. These transactions would include when the noncontrolling interest received (or retained) is a noncontrolling ownership interest in the post-sale owner of the property (including sales to an existing equity method investee), and when the noncontrolling interest is received because of contributing a nonfinancial asset to form a venture.

Under the Phase 2 proposal, when a noncontrolling interest in the buyer/transferee is received or retained, it would be considered noncash consideration (paragraph 606-10-32-21), and its fair value at contract inception would be included in the transaction price. The carrying amount of liabilities assumed by the buyer/transferee also would be included in the consideration received for computing the gain or loss (subject to the constraint on estimating variable consideration in paragraph 606-10-32-11). The seller/transferor's gain on the sale would be equal to the amounts previously illustrated in View C.

The Phase 2 proposal would eliminate the guidance in Topic 845 related to the transfer of a nonfinancial asset for a noncontrolling interest in the buyer (see Question D40).

The proposed unit of account in these transactions would be each distinct asset (or in-substance nonfinancial asset) as opposed to the partial interest transferred. If the transaction does not result in the seller relinquishing control of the nonfinancial asset (or a distinct in-substance nonfinancial asset), the seller/transferor would:

a. record an equity transaction if retention of control results from retaining a controlling financial interest in the entity that owns the asset post-sale (similar to View C previously illustrated), or
b. apply the guidance in 360-10-40-3C.

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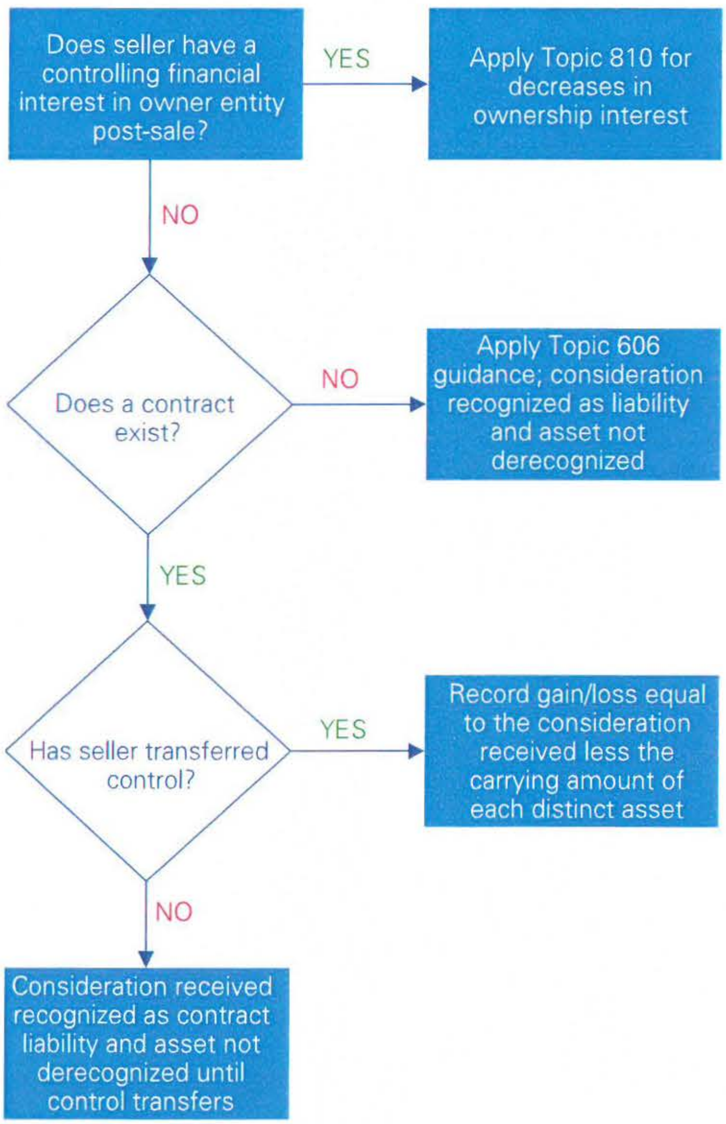
[14] For more information on this project, see Defining Issues 16-21, FASB Proposes to Clarify Scope of Derecognition of Nonfinancial Assets.

[15] For more information on this project, see Defining Issues 15-56, FASB Proposes to Clarify the Definition of a Business.

Paragraph 360-10-40-3C indicates that a seller should consider the guidance in (a) 606-10-25-6 to 25-8, which would result in recognition of a deposit liability for the cash received, if failure to relinquish control results from not having a contract, or (b) 610-10-25-30, if failure to relinquish control results from not transferring control of the asset to the entity that owns the asset post-sale. [606-10-25-1 – 25-8, 25-30, 610-20-40-1]

Because in most cases the subsidiary owns and controls the asset before it sells the third-party ownership interest in the entity, we believe most of these partial ownership sales would qualify for full profit recognition when the seller relinquishes its controlling financial interest in the subsidiary.

The following flowchart depicts the proposed decision sequence:



The proposed guidance in Phase 2 applies only when the seller is transferring a nonfinancial asset or an in-substance nonfinancial asset (i.e. an asset that is included in a group, or subsidiary, in which substantially all of the fair value is concentrated in nonfinancial assets).

When substantially all of the fair value of *a group of assets* is not concentrated in nonfinancial assets (and is not a business), the seller first would apply the revenue guidance on identifying distinct goods and services and allocating consideration to those distinct goods and services. Then, the seller would account for each of the distinct goods and services under the applicable guidance, which generally would be Subtopic 610-20 for the sale of distinct nonfinancial assets.

When substantially all of the fair value of a *subsidiary* is not concentrated in nonfinancial assets (and is not a business), the seller would apply the guidance in Topic 810 on derecognition and decreases in ownership of businesses. This guidance is required for subsidiaries when no other guidance applies. Topic 810 requires full gain or loss in earnings when a controlling financial interest is sold, and no gain or loss in earnings when a controlling financial interest is retained (i.e. the gain or loss is recognized in equity).

See Question A20 for discussion of which sales of ownership interests in real estate entities are within the scope of Topic 606/Subtopic 610-20 versus Subtopic 810-10.

F100. Does the guidance on partial sales discussed in Question 5.9 apply when the venture owns operating real estate that meets the definition of a business?

Generally yes, because an ownership interest in a venture owning operating real estate often is an in-substance nonfinancial asset even if it also meets the definition of a business. As discussed in Question A20, land plus property improvements and integral equipment collectively are considered in-substance real estate, so their sale is accounted for under Subtopic 610-20 (or Topic 606 if the sale is to a customer, via the guidance in Section 360-10-40). This accounting would apply even if all (or part) of the operations of the property otherwise meet the definition of a business for which derecognition would normally be accounted for under Subtopic 810-10. Paragraphs 810-10-40-3A and 810-10-45-21A exclude the transfer of in-substance nonfinancial assets from Subtopic 810-10's guidance on accounting for the deconsolidation, and decrease in ownership, of a subsidiary or business.

If the interest in the venture is not considered an in-substance nonfinancial asset, and the venture is a business (after considering the guidance in Question A20), then partial sales would be accounted for under Subtopic 810-10 (illustrated as View C in Question F90). This would result in 100 percent profit recognition in income when the seller no longer consolidates post-transaction and $0 profit recognition in income when the seller continues to consolidate post-transaction.

While the guidance above reflects possible interpretations of Subtopics 610-20, 810-10 and 970-323 as it currently exists, the FASB is reconsidering this guidance in its project on *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, formerly *Clarifying the Definition of a Business Phase 2* (Phase 2).

In its *Clarifying the Definition of a Business (Phase 1)* project, the FASB proposed to change the definition of a business, which will result in many more real estate transactions being considered purchases or sales of nonfinancial assets rather than businesses.

In Phase 2, the FASB proposed that Subtopic 610-20 would apply when the property (in the form of a single nonfinancial asset or multiple, distinct in-substance nonfinancial assets) does not meet the definition of a business. If the asset (or subsidiary or group of assets) transferred does meet the definition of a business, Subtopic 810-10 would apply. In either case, this generally would result in 100 percent profit recognition in income when the seller no longer consolidates post-transaction, and $0 profit recognition in income when the seller continues to consolidate post-transaction. However, the amount of profit on the sale may differ depending on whether the asset (or subsidiary or group of assets) is a business or a nonfinancial asset because a seller would measure the consideration (a) at fair value in the derecognition of a business, and (b) at the transaction price (which may include an estimate of variable consideration) plus the carrying amount of liabilities assumed by the buyer in the derecognition of a nonfinancial asset.

Comparison to legacy US GAAP

Paragraphs 360-20-40-46 to 40-49 define a sale as a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. Profit equal to the difference between the sales value and the proportionate cost of the partial interest sold is recognized if the:

— buyer is independent of the seller;

— collection of the sales price is reasonably assured; and

— seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

If these conditions are not met and the:

— collection of the sales price is not reasonably assured – the seller applies the cost recovery or installment method of recognizing profit;

— buyer is not independent of the seller, for example, if the seller holds or acquires an equity interest in the buyer – the seller recognizes the part of the profit proportionate to the outside interests in the buyer at the date of sale;

— seller controls the buyer – no profit on the sale is recognized until it is realized from transactions with outside parties through sale or operations of the property; and

— seller is required to support the operations of the property after the sale — the accounting is based on the nature of the support obligation.

Paragraphs 970-323-30-3, 35-15 and 40-1 also address partial sales when (a) the buyer is not independent of the seller because it holds or acquires an equity interest in the buyer, and (b) the seller controls the buyer.

Currently there is some diversity in practice in the accounting for the sale of a noncontrolling interest in a real estate venture when the seller retains a controlling financial interest in the venture. Many sellers do not recognize a sale or immediate profit in such transactions, but some sellers recognize those transactions as partial sales with partial profit recognition. Under the new guidance as currently issued and absent any further direction from the FASB, diversity would likely increase as the interaction between the revenue standard and the deconsolidation guidance in Subtopic 810-10 is less clear. However, as discussed above, the FASB has proposed guidance intended to address these issues, among others, in connection with its *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets* project. See additional discussion in Question F90.

F110. Is a buy-sell clause allowing either investor to make an offer to acquire the other's interest in an entity that holds real estate considered an obligation or a right to repurchase the property from the perspective of the investor that sold the real estate to the entity?

Frequently to facilitate a partial sale transaction, a seller will contribute property to a newly formed entity and a third party will contribute cash so that the seller can take a simultaneous cash distribution for the sale to that third party of an ownership interest in the entity. A contractual buy-sell clause may be included in the terms of the sale that enables both investors in the jointly-owned entity to offer to buy the other investor's interest. In some cases, a buy-sell clause may be executed at any time; in other cases, only at a specified future date or if specified circumstances arise. When an offer is made under the buy-sell clause, the recipient of the offer can elect to sell its interest for the offered amount or buy the offeror's interest at the offered amount. Generally, once an offer is made, the offeror is contractually required to buy the other investor's interest or sell its interest at the offered amount, depending on the other investor's election. A buy-sell clause can specify that the offer be at fair value, at a contractually specified amount, or at an amount determined by the offeror.

We do not believe a buy-sell clause, by itself, precludes the buyer from obtaining control unless it gives the buyer an in-substance option to put its interest back to the seller or gives the seller an in-substance right to reacquire the buyer's interest in the property. If the buy-sell clause is an in-substance put or call option, the seller applies the guidance in Question F60 or Question F70.

A buy-sell clause may be considered an in-substance option when the buyer cannot act independently from the seller, or the seller is economically compelled to reacquire the other investor's interest in the jointly owned entity (reacquiring the property). Those circumstances suggest that the buyer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the property is limited.

We believe the following indicators (which are not all-inclusive) may suggest the buyer has not obtained control:

a. The price specified in the buy-sell agreement indicates that the parties have already negotiated for the seller to acquire the buyer's interest. This would occur when the fixed price specified in the buy-sell clause economically compels the seller to acquire the buyer's interest or economically compels the buyer to sell its interest to the seller.
b. The seller has a strategic necessity or an investment strategy that indicates that it cannot relinquish its ownership rights to the buyer. Therefore, the seller is compelled to reacquire full ownership of the real estate.
c. The seller has arrangements with the jointly-owned entity, such as management or third-party leasing arrangements, that may economically compel the seller to reacquire the real estate to retain the economic benefits (e.g. leasing commissions from lessees) or escape the negative economic consequences (e.g. a below-market contract with the entity).
d. Tax implications economically compel the seller to acquire the buyer's interest in the entity (thereby reacquiring the real estate).
e. Tax implications economically compel the buyer to sell its interest in the entity to the seller.
f. The buyer is financially unable to acquire the seller's interest.
g. The buy-sell clause stipulates a specified rate of return to the buyer (or seller), indicating that the buyer may not fully participate in the rewards of ownership from the real estate.

h. The buyer has a strategic necessity or an investment strategy that requires it to sell its interest to the seller.

i. The buyer is legally restricted from acquiring the seller's interest.

j. The real estate is integrated into the seller's business, so the buyer does not have alternative means available, such as selling to an independent third party, to realize its economic interest.

We believe this guidance applies to both customer and noncustomer transactions.

Comparison to legacy US GAAP

Paragraphs 360-20-40-38 and 55-21A indicate that a buy-sell clause by itself does not constitute a prohibited form of continuing involvement that would preclude profit recognition on the sale of the partial interest. However, the clause would be evaluated in light of all the relevant facts and circumstances to determine whether its terms indicate that the seller has transferred the usual risks and rewards of ownership and does not have substantial continuing involvement. The buy-sell clause also must be evaluated to determine whether it gives the buyer an in substance option to put its interest back to the seller or gives the seller an in-substance option to acquire the buyer's interest in the real estate.

We believe the analysis of whether a buy-sell clause is an in-substance put or call option under Subtopic 360-20 is similar to the analysis under Topic 606, although the resulting accounting may differ depending on the facts and circumstances as discussed in Questions F60 and F70.

F120. What is the accounting consequence when a general partner in a limited partnership sells a property to the partnership for cash (contributed by the limited partners) and a significant receivable?

Under Topic 606, the seller first determines if a contract exists given the significance of the receivable (see Question B10 for discussion about evaluating whether a contract exists and the resulting accounting if it does not). Next, it determines if and when control transfers, which may depend on the facts and circumstances of the transaction and the FASB's final standard on the guidance on partial sales (see Question F90).

Comparison to legacy US GAAP

A seller must account for a sale as a financing, leasing or profit sharing arrangement if it:

— retains a general partnership interest in the entity that purchases its property, and

— holds a receivable from the limited partnership for a significant part of the sales price (defined as a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property).

Topic 606 may result in a change because revenue/profit recognition may be appropriate if a contract exists and control has transferred. The existence of the general partner interest and significant receivable does not preclude revenue/profit recognition under Topic 606 as it does under Subtopic 360-20. [360-20-40-40]

F130. How should a manager recognize revenue associated with variable consideration in a property management services contract when the contract bases the variable consideration on a percentage of the property's operating results?

As discussed in Question E10, the manager will need to determine if the services comprise a series of distinct time increments of property management services. Question C30 provides additional discussion about identifying the performance obligations in a property management services contract. If the manager concludes the services are a series of distinct services (i.e. a series of daily, weekly or monthly management services), it must allocate the variable consideration to the distinct service periods within the single, series performance obligation if:

a. the variable consideration earned for a given distinct service period relates specifically to the manager's services for that period (or an outcome from those services), and
b. allocation of that amount specifically to the distinct service period is consistent with the allocation objective in paragraph 606-10-32-40(b).

If the property management services comprise a series of distinct service periods to which the variable consideration earned each period can be allocated, the manager will not need to estimate the total variable fees that will be earned during the performance obligation period. The variable fees earned each period will be allocated to, and recognized in, each period.

Paragraphs 606-10-55-157B to 55-157E provide an example of a 20-year hotel management service contract with a customer that pays the manager a monthly fee equal to 1 percent of the hotel's revenue. The manager concludes that it has a single performance obligation to provide a series of daily property management services and that its transaction price is entirely variable.

The property manager then must determine if and how to allocate the variable consideration to each of the distinct days of service in the series of daily services under paragraph 606-10-32-39(b). After considering the guidance in paragraph 606-10-32-40, the property manager concludes that the terms of the variable consideration relate specifically to the manager's efforts to transfer each distinct daily service. Therefore, allocating the variable consideration based on the activities performed each day is consistent with Topic 606's overall allocation objective. See Question E10 for additional discussion about allocating the variable consideration.

When determining the relative value of the activities performed each day, we believe in many cases property managers will be able to apply the paragraph 606-10-55-18 practical expedient and recognize revenue in the amount to which they have a right to invoice. They will be able to apply the practical expedient because the terms of the contract intend to provide the property manager the right to consideration in an amount that corresponds directly with the value to the customer of the performance completed each period. However, even if the property manager may apply the practical expedient, it still would need to consider the constraint on variable consideration in 606-10-32-11 to 32-14.

G Other implementation matters

G10. For transition purposes, how would an entity apply the definition of a completed contract when a reduced profit method under legacy US GAAP is being used?

When a reduced profit method under legacy US GAAP is being used (e.g. installment method), for transition purposes an entity adopts Topic 606 using one of the following two methods:

Method 1

Retrospectively by restating each prior period before the date of initial application that is presented in the financial statements (full retrospective). An entity also may elect retrospective application with or without a number of practical expedients.

Method 2

Recording the cumulative effect of initially applying the new standard as an adjustment to the opening balance of equity at the date of initial application (no restatement of comparative prior periods). An entity may apply the cumulative-effect transition approach either to (a) only those contracts that are not completed contracts at the date of initial application, or (b) all contracts.

Paragraph 606-10-65-1(c)(2) defines a completed contract for transition purposes as one for which all (or substantially all) of the revenue was recognized under legacy US GAAP. Real estate sales that have occurred before the date of initial application and met the criteria for full accrual profit recognition under Subtopic 360-20 generally would be considered completed contracts[16] and therefore no adjustment to opening equity would be needed for those transactions (because the adjustment would only be necessary for contracts that are not completed).

[16] We believe, however, that a real estate sale qualifying for full accrual profit recognition under Subtopic 360-20 would not be considered a completed contract in circumstances where there is an ongoing earn-out or other interest in future profits that prevents the entity from concluding that substantially all of the revenue has been recognized before the date of initial application.

Example G10.1: Not a completed contract at transition

Description of the arrangement

ABC Corp. sells a property to DEF Corp. (a customer) for $10,000,000 with a carrying amount of $8,000,000. ABC receives $500,000 at closing on October 1, 2017 and finances the remaining $9,500,000 under a 30-year note receivable. Because DEF's initial investment of $500,000 is not adequate, ABC accounts for the transaction under the installment method prescribed by Subtopic 360-20 (assuming the criteria for the installment method are met). DEF makes its first principal payment on the note of $100,000 on December 31, 2017.

ABC has a calendar year-end, and for purposes of its 2017 annual financial statements, ABC recognizes $600,000 of revenue, $120,000[17] profit on the sale of the property, and deferred profit of $1,880,000.

Evaluation

ABC adopts the Topic 606 on January 1, 2018 and concludes its contract is not complete because it has not recognized substantially all of the $10,000,000 revenue under legacy US GAAP (Subtopic 360-20).

Under the retrospective method, ABC would recast its 2017 financial statements to reflect the property sale under the guidance of Topic 606. If ABC concludes that a contract exists (including that the collection of the note is probable) and control of the property has transferred, then its 2017 financial statements would be recast to reflect revenue of $10,000,000 and profit on the sale of the property for the full $2,000,000 (or gain on sale of $2,000,000 for a transaction with a noncustomer).

Under the cumulative-effect method, ABC does not recast its 2017 financial statements (i.e. revenue of $600,000 and profit of $120,000 recognized in 2017 is unchanged). However, if ABC concludes that a contract exists (including that the collection of the note is probable) and control of the property has transferred, then it records a cumulative-effect adjustment of $1,880,000 to increase opening equity (retained earnings) and derecognizes the property on January 1, 2018.

Conversely, if it concludes that a contract does not exist, then it would record a cumulative-effect adjustment of $120,000 to decrease opening equity (retained earnings) on January 1, 2018 and would continue to recognize the property at its depreciated carrying amount.

[17] $2,000,000 profit ÷ $10,000,000 sales price x $500,000 received at closing plus $2,000,000 profit ÷ $10,000,000 sales price x $100,000 principal payment.

Example G10.2: Not a completed contract at transition

Description of the arrangement

ABC Corp. sells a newly constructed retail property with a cost of $1,200,000 to DEF Corp. (a customer) for $2,000,000 and a right to receive 25% of future operating profits from the property over a 10-year earn-out period. At closing, on October 1, 2017 ABC receives cash of $2,000,000 and expects to collect an additional $420,000 over the earn-out period. ABC has no other continuing involvement in the property and meets all the criteria for full accrual profit recognition under Subtopic 360-20.

In its 2017 financial statements, ABC recognizes revenue of $2,000,000 and profit of $800,000 on the sale of the property and $10,000 of contingent profits for the amounts realized in the period October 1 through December 31, 2017. ABC would recognize a gain of $800,000 on the sale if the transaction were with a noncustomer.

Evaluation

ABC adopts Topic 606 on January 1, 2018 and concludes its contract for the property sale on October 1, 2017 is not complete because it has not recognized substantially all of the expected revenue of $2,420,000 ($2,000,000 + $420,000) under legacy US GAAP (Subtopic 360-20).

Under the retrospective method, ABC would recast its 2017 financial statements to reflect the property sale under the guidance of Topic 606. If ABC concludes that a contract exists and control of the property has transferred, then it would recast its 2017 financial statements to reflect revenue of $2,420,000 and profit on the sale of the property for the full $1,220,000, assuming the variable consideration of $420,000 (representing the future profits interest) is not constrained. ABC would recognize a gain of $1,220,000 if the transaction were with a noncustomer.

Under the cumulative-effect method, ABC does not recast its 2017 financial statements (i.e. profit recognized in 2017 of $810,000 is unchanged). However, if ABC concludes that a contract exists and control of the property has transferred, then it records a cumulative-effect adjustment of $410,000 (total profit under Topic 606 of $1,220,000 minus $810,000 recognized before adoption) to increase opening equity (retained earnings) on January 1, 2018 and derecognizes the property.

G20. How will Topic 606 interact with the new leasing standard when the lease is an operating lease and the lessee reimburses the lessor for certain costs?

As discussed in Question A30, the FASB recently issued ASU 2016-02[18], which creates a new Topic 842. Topic 842 will supersede Topic 840 in 2019 for calendar year end public business entities. (For more information on Topic 842's effective date, see Question A30.)

Topic 842, like Topic 840, includes guidance on separating lease and non-lease components. Paragraphs 842-10-15-28 to 15-32 and 15-38 to 15-42 require a lessor to separate a single contract into each separate lease component and non-lease component and allocate the consideration using the requirements in Topic 606 for allocating the transaction price (i.e. on a relative stand-alone selling prices basis under paragraphs 606-10-32-28 – 32-41).

Lease components will be accounted for under Topic 842, and non-lease components generally will be accounted for under Topic 606 unless other US GAAP is applicable. The lease component will include activities of the lessor that do not transfer a good or service to the lessee separate from the right to use the underlying asset. Those activities are not considered separate components and therefore are not allocated any portion of the consideration in the lease contract. [842-10-15-30]

Typical recurring charges/reimbursements in an operating lease contract include:

— real estate taxes;

— property insurance; and

— common area maintenance.

Real estate taxes and property insurance

As discussed above, reimbursement or payment of the lessor's costs of ownership are not separate components in the lease contract because they do not transfer a good or service to the lessee. For example, certain leases may require the lessee to reimburse the lessor for all or a portion of the real estate taxes or property insurance costs incurred by the lessor as the owner of the property.

Because the payments do not result from transferring a good or service to the lessee separate from the use of the underlying asset, they are not specifically allocated to those activities but are instead simply considered part of the overall consideration in the contract. In many cases, these payments vary based on the lessor's costs and are billed separately (i.e. a net lease). In those cases, the lessor considers the payments variable lease payments and recognizes them in the period in which the facts and circumstances on which the payments are based change. [842-30-25-11(b), 842-10-55-141 – 55-142)]

If the contract also includes a non-lease component (like common area maintenance), variable lease payments (including cost reimbursements) likely will be partially attributed to the non-lease component on the same basis as the fixed consideration under the lease was attributed to the lease and non-lease components. If instead the lessor structures the reimbursement through a fixed adjustment to the base lease payment (i.e. a gross lease), it would consider the adjustment part of the total consideration in the contract, like other fixed lease payments. The lessor then

[18] For more information on ASU 2016-02, see Leases: Issues in Depth.

allocates the total consideration in the contract to the lease component and the non-lease component and generally recognizes the amount it allocated to the lease component over the lease term on a straight-line basis. This would apply even if the lessor itemized that portion of the fixed payment in the contract for cost reimbursement. [842-10-55-143, 842-30-25-11(a)]

Common area maintenance

Some leases also may require the lessee to pay the lessor for common area maintenance such as cleaning, parking lot maintenance and provision of utilities. Unlike real estate taxes and insurance, common area maintenance is not a cost of ownership of the leased property, but instead is a service the lessor provides or contracts for the lessee for its ongoing use of the property. [842-10-55-144 – 55-145]

Under Topic 842, common area maintenance is a non-lease component that will be separated from the lease component. As previously discussed, the overall contract consideration is allocated between the two components generally on a relative stand-alone selling price basis; the allocated revenue associated with the common area maintenance services will be accounted for under Topic 606 and the allocated lease income associated with the lease component will be accounted for under Topic 842.

Because Topic 842 and Topic 606/Subtopic 610-20 are effective at different dates (and the guidance on separating lease and non-lease components differs between Topic 840 (current leases Topic) and Topic 842 (new leases Topic)), lessors should consider whether early adoption of Topic 842 to coincide with the adoption of Topic 606/Subtopic 610-20 would reduce their total transition efforts.

G30. Does new Topic 340 change whether an entity can capitalize costs incurred to sell real estate projects?

Topic 340 supersedes the guidance in Subtopic 970-340 on accounting for costs incurred to sell real estate projects. Those costs generally will now be evaluated for capitalization using guidance on the incremental cost of obtaining a contract and costs to fulfill a contract. [340-40-25-1 – 25-8]

An incremental cost of *obtaining* a sales contract is a cost that would not have otherwise been incurred if the contract were not obtained. An entity capitalizes[19] those costs under Topic 340 if it expects to recover them. Costs that an entity would have incurred regardless of whether it obtained a sales contract are recognized under Topic 340 as an expense when incurred, unless those costs are capitalizable under other guidance or explicitly chargeable to the customer regardless of whether or not a contract was obtained.

In many cases, the seller would have incurred indirect costs of obtaining a sales contract such as model units and their furnishings, sales facilities, legal fees for preparation of prospectuses and semi-permanent signs regardless of whether the seller obtained a contract. The seller generally does not attribute these costs to a specific contract. As a result, the seller generally would expense these costs as incurred unless they are within the scope of another topic; for example, model units and sales facilities may be long-lived assets under Topic 360.

[19] As a practical expedient, an entity may recognize the incremental cost of obtaining a contract as an expense when incurred if the amortization period of the asset that would have otherwise been recorded is one year or less.

If the costs incurred to *fulfill* a sales contract are in the scope of other guidance, then the entity accounts for them using the other guidance (e.g. Topic 360). Otherwise, an entity recognizes an asset only if the costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

The current US GAAP guidance on the costs incurred to *rent* real estate projects other than initial direct costs is unchanged by ASU 2014-09. The costs associated with model units and their furnishings, rental facilities, semi-permanent signs, grand openings and unused rental brochures are capitalized if they relate to, and their recovery is reasonably expected from, future rental operations and rental overhead is expensed as incurred. Topic 310 defines initial direct costs and Subtopic 840-20 prescribes their accounting. [970-340-25-16 – 25-17]

As previously discussed, the FASB recently issued ASU 2016-02[20], which creates a new Topic 842. Topic 842 will supersede Topic 840 in 2019 for calendar year-end public business entities. (For more information on Topic 842's effective date, see Question A30).

Topic 842 also amends Topic 310 to require that initial direct costs associated with leasing activities be accounted for under Topic 842. That standard defines initial direct costs as incremental costs of a lease that the lessor would not have incurred if it had not obtained the lease (e.g. commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease).

The guidance excludes from the definition of initial direct costs those costs that the lessor would have incurred regardless of whether it obtained the lease. These exclusions include the costs to negotiate or arrange a lease, such as fixed employee salaries, general overhead, advertising, tax and legal advice, and evaluating a prospective lessee's financial condition. [842-10-30-9 – 30-10]

Only those costs that are considered initial direct costs are eligible for deferral and, if deferred, recognized over the lease term. Many of the costs incurred to rent real estate projects that are currently capitalized under Subtopic 970-340 (and some costs that currently are considered initial direct costs under Topic 310), will be expensed as incurred when Topic 842 becomes effective. [842-30-25-1(c), 25-8, 25-10]

[20] For more information on ASU 2016-02, see Leases: Issues in Depth.

Index of questions and answers

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 29, 2015

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Technical Director
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Delivered Electronically

Re: Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Deferral of Effective Date*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide support and input to the Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Deferral of Effective Date* (the Proposal). For reasons discussed further below, NAREIT agrees that the Financial Accounting Standards Board (FASB or Board) should defer the effective date of *Revenue from Contracts with Customers* Standard (the *Revenue Recognition* Standard).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index, which covers both

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Equity REITs and Mortgage REITs. This Index contained 220 companies representing an equity market capitalization of $966 billion at March 31, 2015 Of these companies 179 were equity REITs representing 93.6% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $904 billion)[1]. The remainder, as of March 31, 2015, is represented by 41 stock exchange-listed mortgage REITs with a combined equity market capitalization of $62 billion.

NAREIT Recommendation

NAREIT concurs with the Proposed Deferral of the *Revenue Recognition* Standard. While NAREIT does not have a strong preference for a one year or two year deferral, NAREIT recommends that the Board align the effective date with that of other standard setting on the Board's agenda that will impact the real estate industry (*i.e., Leases, Clarifying the Definition of a Business*, and *Revenue Recognition – Identifying Performance Obligations and Licenses* Projects).

Revenue Recognition and Leases Projects

Through our evaluation of exposure drafts and observing the Boards' ongoing re-deliberations, NAREIT has identified the following examples where the *Revenue Recognition* and *Leases* Projects are interrelated:

- Scope - The *Revenue Recognition* Standard clearly excludes leases from the scope of the standard. Similarly, if a contract does not meet the definition of a lease within the *Leases* Proposal, then the contract would probably be subject to the *Revenue Recognition* Standard for the party providing the service.

- Accounting for Sales-type Leases by Manufacture/Dealers – While leases are outside the scope of the new *Revenue Recognition* Standard, accounting for sales-type leases would be in scope. The timing of profit recognition will be determined by whether control has passed from the seller to the purchaser pursuant to the new *Revenue Recognition* Standard.

- Sale-leaseback transactions – While leases are outside the scope of the new *Revenue Recognition* Standard, accounting for sales would be in scope. Whether or not sales treatment is achieved will impact the ensuing treatment of the lease transaction.

- Collectability – Collectability of rent by the lessor assessed pursuant to the new *Revenue Recognition* Standard will affect the lessors' accounting (We note here in passing that both Type A lease receivables and residual values and Type B lease receivables will be subject to the new impairment guidance under development).

[1]https://www.reit.com/sites/default/files/reitwatch/RW1504.pdf at page 21.

Revenue Recognition – Identifying Performance Obligations and Licenses and *Leases* Projects

An area that continues to be of particular interest is the accounting treatment for tenant reimbursements by lessors. In a situation where a gross lease is negotiated between a landlord and tenant, the lease agreement will specify a single amount that the tenant will pay in rent. This amount will include other items beyond the payment to rent the space, including common area maintenance, taxes, insurance, and perhaps other services. Preparers and auditors alike continue to grapple with whether a portion of the rent payment should be allocated to these other embedded items. In our view, the answer to this question could have a significant impact on the financial statements. For example, this could impact the amount of the lease payables and receivables recognized on the balance sheet, income statement presentation, and footnote disclosure in the lease commitment table.

Revenue Recognition and *Accounting for Sales of Real Estate*

The determination of whether real estate meets the definition of a business under the FASB's *Clarifying the Definition of a Business* Project could have a significant impact on accounting for sales of real estate including, most notably, partial sales of real estate. If real estate does not meet the definition of a business, the accounting treatment of the sale will presumably follow the new *Revenue Recognition* Standard. If real estate meets the definition of a business, the accounting treatment for the sale may ultimately be outside the scope of the *Revenue Recognition* Standard, and be subject to Consolidation guidance. A complicating scenario that has not yet been addressed by the new *Revenue Recognition* Standard is the accounting treatment for partial sales of real estate. With the removal of sections of Accounting Standards Codification (ASC) 360 *Property, Plant, and Equipment* that deals with sales of real estate (formerly FAS 66 *Accounting for Sales of Real Estate*), questions surround how to account for partial sales of real estate.

Transition

Because of the significance of these other Projects and their interrelationship to the *Revenue Recognition* Standard, NAREIT does not support an option to early adopt the *Revenue Recognition* Standard. Further, NAREIT values comparability across the industry to be of utmost importance so that investors and analysts can readily compare the operating performance of NAREIT member companies.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

Respectfully submitted,

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Vice President, Financial Standards
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NATIONAL ASSOCIATION OF
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June 30, 2015

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Delivered Electronically

Re: Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing* (the Proposal or ED). This letter provides comment only on the issue of clarifying the guidance on when promised goods and services are distinct for purposes of identifying performance obligations.

NAREIT agrees that the Financial Accounting Standards Board (FASB or Board) should clarify the guidance for identifying performance obligations. However, we do not believe that the proposed clarifications (or the original language in Topic 606) provide sufficient clarity on an issue of great importance to our member companies – whether commitments by the lessor/landlord to pay property taxes, maintain insurance, and provide common area maintenance related to leased real estate should be treated as being distinct from the obligation to provide the leased space to the lessee. We therefore request that the FASB clarify that such obligations are not distinct from the leased space either through an example or revised wording as it finalizes the amendments proposed in the ED, and make corresponding changes for the accounting guidance on separating lease and non-lease components that is included within the Proposed *Leases* standard.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses

♦ ♦ ♦

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throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 221 companies representing an equity market capitalization of $926 billion at April 30, 2015. Of these companies, 180 were Equity REITs representing 93.3% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $864 billion)[1]. The remainder, as of April 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $62 billion.

NAREIT Comments

NAREIT concurs that the guidance in Topic 606 on determining whether promised goods or services are "distinct in the context of the contract" would benefit from additional clarity. NAREIT's main focus relating to the identification and separation of performance obligations has been voiced in previous comment letters submitted in response to both the *Revenue Recognition* and *Leases* Proposals. The issue that NAREIT identified deals with whether lessor commitments to pay property taxes, maintain insurance and perform common area maintenance should be bifurcated from revenue from space rent. Preparers and auditors have questioned whether this was the Board's intention when the Board deliberated the separation of performance obligations in the new *Revenue from Contracts with Customers* standard as well as the separation of lease and non-lease components in the new *Leases* proposal.

Based on our reading of the current *Leases* revised exposure draft, lease revenue may be required to be separated between lease and non-lease components. Lease components would be subject to the new *Leases* accounting guidance, while non-lease components would be subject to the new *Revenue from Contracts with Customers* standard. Because Topic 606 may require that revenue within its scope be presented separately from other revenue, separation would effectively result in a need to present lease revenue separately from revenue from the related tax, insurance and CAM services.

In our view, commitments to pay taxes, maintain insurance, and perform common area maintenance that are included in a lease agreement are highly interdependent and highly

[1] https://www.reit.com/sites/default/files/reitwatch/RW1505.pdf at page 21.

interrelated[2] with the use of the leased real estate. The lessee would not be able to use the leased space in an office building or a shopping center if the real estate:

- was subject to a tax lien,
- did not have an active insurance policy to satisfy its debt agreement on the property, or
- was not properly maintained.

The purpose of the transaction is to lease space in exchange for market rent. Lessees cannot go to the market and separately contract for tax collection services, separate insurance contracts for the structure of a specific office space on/within a floor of a building, or contract with cleaning and maintenance services to clean the common area contiguous to the tenant's space. Given the highly interrelated nature of the tenant reimbursements and the space rent, we believe that the income statement should reflect all of these payments in a single line item[3]. While we believe that the application of the principles of Topic 606, as issued, does not require that such promises be treated as performance obligations distinct from the leased space, some audit firms have espoused different views. As such, while we believe the language in the Proposal also would not require tax, insurance and CAM commitments to be treated separately, we are concerned that differing views will continue.

In order to ensure proper application of the new *Leases* and *Revenue from Contracts with Customers* standards, NAREIT recommends that the Board include an illustrative example that demonstrates how the standards would apply to lease agreements containing tenant reimbursements. NAREIT would be happy to assist the Board in developing an illustration consistent with market realities for inclusion in the final standards.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

[2] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166005104&acceptedDisclaimer=true at paragraph 606-10-25-21(c).

[3] In order to meet the needs of investors, NAREIT believes that components of lease revenue that vary directly with related costs (as is often the case is a so-called "net lease", in which a fee is stated for the leased space, with allocations of applicable costs paid in addition to that stated fee) should be disclosed in the notes to the financial statements. To the extent that the lease agreement includes a single rental payment, with no additional amounts paid for allocation of common costs, NAREIT believes the needs of investors would be met with disclosure of the costs incurred for these items, as opposed to requiring an artificial bifurcation of revenue. In our view, these disclosures would adequately convey information about the risks either taken on by the lessor, or passed on to the lessee.

Respectfully submitted,

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Governance Insights Center

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Approaching the 2016 year-end financial reporting season

Five things for audit committees to think about

The 2016 calendar year-end financial reporting season is approaching and audit committees are preparing for their year-end meetings. Here, we highlight some of the financial reporting issues, SEC trends and other developments that audit committees should be thinking about.

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1. Are we on course to adopt the new revenue recognition standard?

In May 2014, the FASB issued its new standard on revenue recognition. The standard, which largely removed industry-specific guidance, is meant to allow investors to better compare financial statements across companies and industries. It is also intended to simplify today's revenue recognition guidance by making it principles-based. But, depending on the company or industry, the new standard could greatly change the timing of, recognition of, and, in some cases, the amount of, revenue compared to the current rules. These changes could have ripple effects on key performance measures and debt covenant ratios, and could ultimately affect contract negotiations, budgets, and even business models.

What should the audit committee be thinking about?

The 2018 effective date may seem far away, but audit committees need to be thinking about the new standard now. Many companies have experienced or anticipate difficulties implementing the new standard—with a potentially time-consuming review of customer contracts topping the list of implementation challenges. Yet our research finds that three-fourths of public companies are still assessing the impact, and only 17% say they have taken the next step toward implementation.[1] The SEC has been closely watching and has expressed some concern over company readiness.[2]

When is it effective?

For calendar year companies, the new FASB standards will take effect in the first quarter of 2018. Non-calendar year companies must comply during the first interim period within annual reporting periods beginning after December 15, 2017. Nonpublic entities have an additional year. A company can apply the new revenue standard retrospectively, including using certain practical expedients. Or, the cumulative effect of applying the new standard to existing contracts can be reflected in the opening balance of retained earnings on the effective date—with proper disclosures.

1 PwC/FERF, *2016 Revenue recognition survey*, 2016.

2 SEC Chief Accountant Wesley R. Bricker, Remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments, December 5, 2016.

In light of this, audit committees should review their companies' proposed implementation timeline. Does it align with the effective date? Is it realistic given the complexity of the company's operations, business model and attendant revenue streams as well as the policy, system, process and control updates required?

Audit committees will want to understand:

- How management has interpreted the new standard and its assessment of the impact on the company's revenue model
- Management's project plan for implementation, including when key milestones will be met
- How new decision points and required disclosure will affect IT systems, processes, and internal controls, and how management is evaluating existing contracts, revenue models, and business practices
- Whether current filings properly disclose the potential impact of the new standard, if known
- The expected impact on pay programs and any related changes to company policies and practices
- The impact on current business activities, contract negotiations, budgeting, and key metrics

Where to go for more information:

CFOdirect resources on revenue recognition

Accounting advisory resources on revenue recognition

2. Are we comfortable with the company's use of non-GAAP measures?

Use of non-GAAP measures in company filings has grown over the past several years, as companies seek to give investors what they see as a fuller picture of company performance. SEC regulations allow the use of these measures, but there are strings attached (such as needing to present the most comparable GAAP figure first and including a reconciliation of the non-GAAP amount to the GAAP figure). In recent years the SEC has targeted the use of non-GAAP measures that it believes could be potentially misleading to investors. And in May 2016, the SEC staff issued clarifying guidance on the use of these measures. The update calls out potentially problematic practices, including:

- Performance measures that exclude normal, recurring cash operating expenses necessary to operate a company's business
- Use of non-GAAP measures inconsistently between periods without disclosing the change and the reasons for change
- Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains
- Individually-tailored accounting principles used to calculate non-GAAP earnings—for example, a non-GAAP revenue metric that accelerates revenue recognition
- Disclosures that cause a non-GAAP measure to be more prominent than the closest comparable GAAP measure

Recent SEC comment letters on the topic have focused on a few key areas. The most common issue identified is the failure to include the most directly comparable GAAP financial measure with equal or greater prominence. The SEC is also frequently asking companies to explain how the non-GAAP measures help investors understand the company's operations and financial results. Additionally, the SEC has targeted improper labeling of non-GAAP measures that sound too similar to a GAAP measure.

What should the audit committee be thinking about?

Audit committees will want to understand what non-GAAP measures are being used in filings, and why. They should ask management how they will ensure that when the measures are used, it is done in line with the new SEC guidance. Audit committees will also want to:

- Read the disclosure that includes non-GAAP measures (and other key metrics communicated to analysts) and decide whether it is fair, balanced, and transparent
- Understand how management ensures that the calculation of the non-GAAP measures and other key metrics are accurate and consistent with those of prior periods considering that the information is not typically covered by a company's internal control over financial reporting and is not audited
- Look to peers to evaluate whether use of non-GAAP measures is commonly accepted and measures used are similar
- Understand how non-GAAP measures could affect executive compensation
- Evaluate whether the use of these measures complies with SEC regulations and updated guidance

Where to go for more information:

Audit Committee Excellence Series: To GAAP or non-GAAP? The SEC is watching

3. How will we be impacted by the new lease accounting standard ?

In February 2016, the FASB issued a new standard on lease accounting. The new standard could impact almost all companies to some extent, but lessees will likely see the biggest changes. Lessees will now need to recognize virtually all of their leases on the balance sheet (i.e., a liability for the future lease payments and a corresponding right-of-use asset), even if the lease is embedded in another arrangement, such as a long-term contract. Each lease also needs to be classified as an operating or finance lease. Operating leases will have straight line rent expense. Finance leases will follow a traditional interest-amortization model.

When is it effective?

For most calendar year entities, the new FASB standards will take effect in the first quarter of 2019. Private companies have an additional year to comply. Companies are required to adopt the standard using a modified retrospective transition approach, which requires application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption. Early adoption is permitted. Lessors may want to consider interactions with the revenue standard and adopt at the same time.

Although this is an accounting change, systems and data issues will likely present challenges for companies. In preparation, management will need to identify and review all existing leases and other contracts that may contain embedded leases. Once the leases are identified, all lease terms will need to be analyzed to measure the amounts that will go on the balance sheet. This could be a time-consuming and difficult effort, depending on the number of leases, their variety and complexity, the availability of records, and the sophistication of current systems.

What should the audit committee be thinking about?

Management will need to discuss with the audit committee how it is analyzing the impact of this new standard on the company. Audit committees will also want to understand:

- The effort required to get the information necessary, and the planned timeline to ensure adoption by the required date
- Management's process for creating a complete and accurate inventory of leases
- How management has evaluated the impacts beyond financial reporting (e.g., debt covenants, apportionment of income for state taxes, and determining whether to lease or buy in the future)

Where to go for more information:

Accounting advisory resources on lease accounting standards

10Minutes on the new US lease standard

4. Should we enhance our audit committee proxy disclosures?

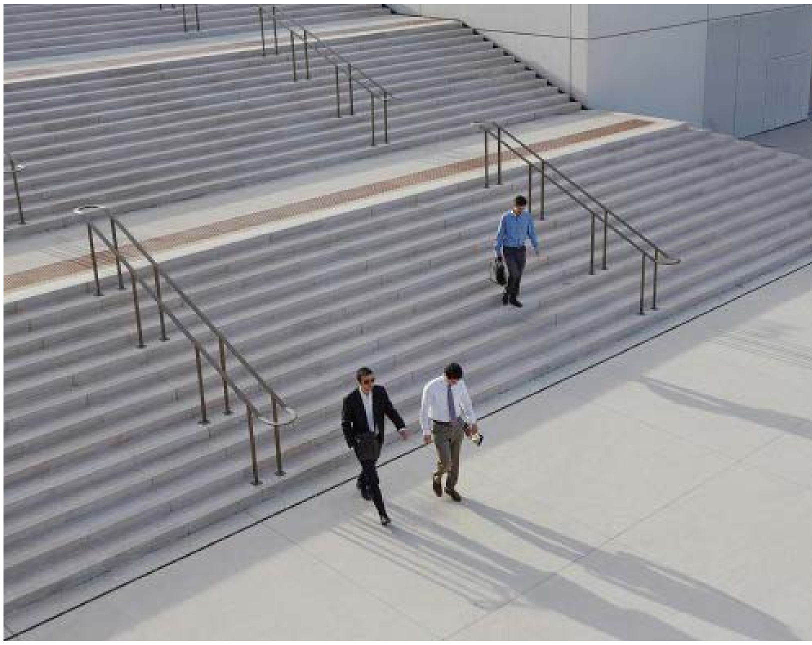
Over the last several years, there has been a growing interest by investors, regulators, and other stakeholders in better understanding the audit committee's role in oversight of the external auditor. In response, a growing number of audit committees have chosen to voluntarily provide more relevant and useful information to investors and other stakeholders about how they perform their role. And recent research affirms the continued rise in such voluntary proxy disclosures by S&P 500 companies.[3] In particular:

- *Audit partner selection*—43% now state that the audit committee is involved in audit partner selection, compared to 13% in 2014
- *Audit firm evaluation/supervision*—34% now discuss criteria considered when evaluating the audit firm, up from 8% in 2014
- *Audit firm selection/ratification*—31% now disclose the audit committee's considerations in recommending the audit firm's appointment, up from 13% in 2014
- *Audit firm compensation*—17% now explicitly state the role the audit committee plays in negotiating audit fees, up from 8% in 2014

What should the audit committee be thinking about?

Audit committees considering changes should re-read their previous disclosure with an eye to how they can better explain the work that they do to investors and other stakeholders. Audit committees will also want to consider:

- Asking management to propose sample disclosure covering the categories to the left, and others tracked in the Center for Audit Quality's *2016 Audit Committee Transparency Barometer*
- Benchmarking proxy disclosures of peers and competitors
- Reviewing the proxies of companies that have already embraced enhanced disclosure



3 Center for Audit Quality/Audit Analytics, *2016 Audit Committee Transparency Barometer,* November 2016.

5. Do we have our arms around recent developments in the income tax space?

As audit committees think about where to spend more time, the income tax area may be moving up the list. A number of issues are converging in this area, including a continued emphasis by the SEC staff on income tax disclosures as noted in comment letters, and a new FASB standard related to tax accounting for intercompany transactions.

In addition, there are developments in the way governments—including the US—are looking at changing tax laws or furthering enforcement. For example, governments around the world facing budget shortfalls are questioning whether multinational companies are paying their “fair share” of taxes. The OECD’s[4] base erosion and profit shifting (BEPS) project is likely to spur significant changes in the taxation of international businesses in the future, and may trigger the need for changes to companies’ tax structures.

There have been several recent developments in the tax area that audit committees should be aware of:

- **FASB standard update on intra-entity transfers.** In October 2016, the FASB issued new guidance that will require the immediate recognition of the current and deferred tax consequences from an intra-entity asset transfer of an asset other than inventory. One such example would be the sale of intellectual property. This guidance is effective in 2018 but can be adopted in 2017, but only during the first quarter. When adopted, this new guidance could have a significant impact on the company’s effective tax rate.
- **Internal Revenue Code (IRC) Section 385 regulations.** Also in October 2016, the US Treasury Department and Internal Revenue Service finalized new regulations under Section 385, which relates to intercompany borrowings. The new rules are intended to minimize the ability of US entities to deduct interest on certain borrowings from foreign related parties by treating them as equity instead of debt for US federal tax purposes. Depending on a company’s global structure, this change in tax law could have an impact going forward. Generally, there is no impact until 2017 but the rules may apply to arrangements already in place. The new regulations also impose significant new documentation requirements.

4 The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organization with 35 member countries.

Looking forward, tax reform is certainly top of mind in Washington and around the world. President-elect Trump's call for action on comprehensive tax reform, including significantly lowering business income tax rates, is expected to receive strong support from Republicans in Congress. House Republicans have been drafting language for the tax reform "blueprint" that they released earlier this year, which differs in some respects from Trump's tax proposals. House Speaker Paul Ryan (R-WI) has said a Republican-controlled Congress could quickly adopt tax reform in 2017 by using "budget reconciliation" procedures that allow legislation to be approved in the Senate with a simple 51-vote majority, instead of the 60 votes generally needed to advance legislation.

What should the audit committee be thinking about?

Audit committees will want to understand the impact of recent developments in tax policy on a global basis and stay updated on the potential impact of US tax reform efforts under the new administration. Audit committees will also want to:

- Understand the potential impact of the OECD's BEPS project on the global tax picture
- Discuss with management their assessment of the impact of the new FASB guidance on intra-entity asset transfers and IRC Section 385 regulations
- Stay updated on recent trends in SEC comment letters related to income taxes to assess the adequacy of current disclosures and other areas of focus

Where to go for more information:

10Minutes on the OECD's BEPS project

In brief: FASB simplifies tax accounting for intra-entity asset transfers

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

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