Publications in Deloitte’s Roadmap Series

Business Combinations

Business Combinations — SEC Reporting Considerations

Carve-Out Transactions

Comparing IFRS Standards and U.S. GAAP

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Current Expected Credit Losses

Debt

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Preface

December 2020

To the clients, friends, and people of Deloitte:

We are pleased to present the 2020 edition of A Roadmap to Applying the New Revenue Recognition Standard (“Revenue Roadmap”). Since the issuance of the new revenue standard on May 28, 2014, the FASB¹ and the International Accounting Standards Board (IASB®), along with stakeholders from all industries, have focused on implementation efforts related to the adoption of ASU 2014-09² and IFRS 15 (and related ASUs and IFRS® Standards). Since the TRG’s initial formation in June 2014, there have been eight TRG meetings (including two FASB-only TRG meetings), at which 52 staff papers in aggregate were discussed.³ The feedback the FASB received through these meetings resulted in multiple ASUs amending aspects of ASC 606 and related topics in the FASB Accounting Standards Codification (the “Codification”). Further, the FASB deferred the effective dates twice by issuing ASU 2015-14 and ASU 2020-05.

The past several years have also seen significant activity by the 16 AICPA revenue recognition industry task forces. The task forces have worked on updates to the AICPA’s industry guides that address over 130 accounting matters related to revenue recognition, presentation, and disclosure.

The SEC staff has been active as well. In addition to monitoring implementation efforts and discussing its expectations for transparent disclosures, the staff has updated its revenue guidance with the issuance of SAB 116, which effectively supersedes SAB Topic 13. In addition, at the July 20, 2017, EITF meeting, the SEC staff provided significant relief to registrants that are required to include financial statements or financial information of other reporting entities in their SEC filings. Specifically, the SEC staff announced that it would not object to elections by certain public business entities (PBEs) to use the non-PBE effective dates for the sole purpose of adopting the FASB’s new standards on revenue and leases.

The 2020 edition of Deloitte’s Revenue Roadmap includes additional guidance and examples that reflect (1) all significant standard-setting and SEC developments through the September 16, 2020, FASB meeting and (2) our own interpretations in light of those developments. In addition, we have reorganized much of the Roadmap’s content (e.g., by reformatting the Q&As of last year’s edition as narrative text) to present it in a more user-friendly manner.⁴ We hope that this update will enable you to navigate some of the more challenging aspects of the new revenue standard. This publication has been developed for readers who have been following every development of the standard, as well as for readers who have not been following all developments and may be working through the standard for the first time. 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

¹ For a list of abbreviations used in this publication, see Appendix F.
² For a list of the titles of standards and other literature referred to in this publication, see Appendix E.
³ In total, the FASB issued 60 TRG Agenda Papers consisting of 52 staff papers, 6 meeting summaries, and 2 research updates.
⁴ For a summary of key changes made to this Roadmap since publication of the 2019 edition, including a mapping of prior Roadmap Q&As to current Roadmap sections, see Appendix G.
all-encompassing guide for those who are still building up their knowledge base to lead or work through an implementation.

Although the new standard is now effective for most companies, we expect additional implementation challenges to arise as (1) business models emerge or evolve and (2) contracts are created or amended. Accordingly, we will continue to develop guidance that we believe will help stakeholders with interpreting the standard.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the Roadmap from the Roadmap Series page on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We encourage you to use this Roadmap as a guide throughout your application of the new revenue standard and to contact us with any questions or suggestions for future improvements. However, the Roadmap is not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

We look forward to assisting you on whatever journey you have remaining and hope that you find this Roadmap integral to your success.

Sincerely,

Deloitte & Touche LLP
Contacts

Sandie Kim
Partner
Deloitte & Touche LLP
+1 415 783 4848
sandkim@deloitte.com

Kristin Bauer
Partner
Deloitte & Touche LLP
+1 312 486 3877
kbauer@deloitte.com

Chris Chiriatti
Managing Director
Deloitte & Touche LLP
+1 203 761 3039
ccchiriatti@deloitte.com

Mark Crowley
Managing Director
Deloitte & Touche LLP
+1 203 563 2518
mcrowley@deloitte.com

Peggy Cullen
Partner
Deloitte & Touche LLP
+1 312 486 9139
pculleen@deloitte.com

Susan Fenney
Partner
Deloitte & Touche LLP
+1 415 783 7654
sfennedy@deloitte.com

Dennis Howell
Partner
Deloitte & Touche LLP
+1 203 761 3478
dhowell@deloitte.com

Eric Knachel
Partner
Deloitte & Touche LLP
+1 203 761 3625
eknachel@deloitte.com
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 IFRS Standards 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 Six joint TRG meetings
2015 (Aug) ASU 2015-14 on change in effective date
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 (Nov) Eighth TRG meeting (FASB only)
2016 (Dec) ASU 2016-20 on technical corrections and improvements
2017 U.S. GAAP — early adoption election year
2017 (Aug) SAB 116 issued
2018 Effective date of final standard (2019 or 2020 nonpublic)  

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1 For public business entities, the new revenue standard became effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. As a result, calendar-year-end companies were required to apply the new revenue standard in 2018. See Chapter 16 for further discussion of effective date and transition.

2 For entities that are not public business entities, the new revenue standard became effective for annual reporting periods beginning after December 15, 2018, and for interim reporting periods within annual reporting periods beginning after December 15, 2019. However, in June 2020, the FASB issued ASU 2020-05, which permits those nonpublic entities that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, to adopt the new revenue standard for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. See Chapter 16 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, the full TRG met and discussed topics that preparers, auditors, and industries had elevated to the TRG’s attention. In addition, the FASB-only version of the TRG met in April 2016 and November 2016. With the help of input from the TRG, the boards issued additional revenue guidance and interpretations (see Chapter 20 for more information). Both the FASB and the IASB have indicated that no future TRG meetings are scheduled and that the TRG will not meet unless additional significant, pervasive issues are identified. However, the FASB has indicated that stakeholders may submit inquiries through its technical inquiry process.³

In January 2016, the IASB issued an announcement that it had completed its decision-making process related to clarifying the new revenue standard and that it did not plan to schedule any additional TRG meetings for IFRS constituents. However, the FASB continued to address implementation issues. As noted above, two FASB-only TRG meetings were held, one in April 2016 and the other in November 2016. At the November 2016 FASB-only TRG meeting, the FASB announced that no additional TRG meetings were scheduled. However, the FASB encouraged stakeholders to continue submitting implementation questions either directly to the TRG or through the FASB’s technical inquiry process. While it acknowledged that it would be open to scheduling future TRG meetings to discuss implementation issues that are significant and far-reaching, the FASB noted that it would be judicious in selecting topics, partly because the Board did not want to disrupt the implementation activities of entities that were adopting the standard as of January 1, 2017. As of the issuance date of this publication, there have been no additional TRG meetings since November 2016.

In August 2017, the SEC issued SAB 116, which effectively rescinded the SEC’s legacy revenue recognition guidance in SAB Topic 13, Securities Exchange Act Release No. 23507, and Accounting and Auditing Enforcement Release No. 108. As part of this update, the SEC’s legacy guidance on bill-and-hold arrangements is no longer applicable upon the adoption of ASC 606 (i.e., entities should look to the guidance in the new revenue standard to determine the appropriate accounting for bill-and-hold arrangements). Refer to Section 8.6.9 for additional information on bill-and-hold arrangements. In addition, SAB 116 notes that SAB Topic 8 will no longer be applicable for retail companies. Further, SAB 116 modified the miscellaneous disclosure guidance in SAB Topic 11.A. For additional information about SAB 116 and other relevant SEC activities, refer to Chapter 20.

³ Information about the technical inquiry process is available on the FASB’s Web site.
Chapter 1 — Overview

1.1 Background
In May 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 from contracts with customers and supersedes most legacy revenue recognition guidance, including industry-specific guidance.\(^1\)

The goals of the revenue recognition project were to clarify and converge the revenue recognition principles under U.S. GAAP and IFRS Standards and to develop guidance that would streamline and enhance revenue recognition requirements while also providing “a more robust framework for addressing revenue issues.”\(^2\) The boards believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

1.2 Key Provisions of the New Revenue Standard
The core principle and application of the new standard’s revenue model can be depicted as follows:

<table>
<thead>
<tr>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>When? The entity satisfies a performance obligation by transferring a good or service to the customer.</td>
</tr>
<tr>
<td>How much? Amount to which the entity expects to be entitled (i.e., transaction price) allocated to the distinct goods or services.</td>
</tr>
</tbody>
</table>

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.

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\(^1\) Unless otherwise indicated in this Roadmap, references to the new revenue standard or to the guidance therein denote the guidance in ASU 2014-09, as amended. For a list of ASUs that amend the guidance in ASU 2014-09, see Section 20.3.3.

\(^2\) Quoted from ASU 2014-09.
• How much?
  ◦ That is, how much revenue may an entity recognize?
  ◦ 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 4 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:
1.3 Scope (Chapter 3 of the Roadmap)

The standard's revenue guidance applies to all contracts with customers as defined by the 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 Codification. The guidance does not apply to contracts within the scope of ASC 840 and ASC 842 (leases) and ASC 944 (financial services — 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 ASC 845 (nonmonetary exchanges between entities in the same line of business to facilitate a sale to another party).

Certain provisions of the standard's revenue guidance 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 to noncustomers 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, such as that in ASC 360-20, has been amended or superseded). See Chapter 18.

1.4 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.

A contract can be written, verbal, or implied; however, the guidance 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 IFRS Standards. 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 IFRS Standards, “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 IFRS Standards in determining whether a contract exists. For more discussion on differences between U.S. GAAP and IFRS Standards, 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.

1.5 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 units of accounting (this process is sometimes called “unbundling”). These distinct goods or services are referred to as “performance obligations.”

The guidance requires an entity to evaluate the promised “goods or services” in a contract to determine each performance obligation (i.e., the unit of accounting). A performance obligation is a 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 guidance addresses the identification of distinct performance obligations in contracts involving the following:

- Warranties (see Section 5.5).
- Customer options to acquire additional free or discounted goods or services (see Chapter 11).
- Nonrefundable up-front fees (see Section 5.6).
The following decision tree illustrates the process for identifying performance obligations in a contract:

1. Identify all explicitly and implicitly promised goods and services in the contract.
2. Are all promised goods and services material in the context of the contract?
   - Yes: Continue with the analysis for each material promised good or service as follows.
   - No: Exclude immaterial promises from further analysis.
3. Is the good or service (or bundle of goods and services) capable of being distinct?
   - Yes: Iseach distinct good or service a performance obligation satisfied over time, and does each performance obligation satisfied over time have the same measure of progress? Refer to Chapter 8.
   - No: Combine two or more promised goods or services and reevaluate the new bundle.
4. Is the good or service (or bundle of goods and services) capable of being distinct?
   - Yes: Continue with the analysis for each material promised good or service as follows.
   - No: Exclude immaterial promises from further analysis.
5. 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? Refer to Chapter 8.
   - Yes: Account for the series of distinct goods or services as a single performance obligation.
   - No: Account for the distinct good or service as a performance obligation.
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 standard 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 standard’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 legacy guidance in ASC 605-25 on determining whether a good or service has “stand-alone value.” However, the standard’s guidance 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 provides the following indicators that two or more promises are not separately identifiable:

- “The entity provides a significant service of integrating 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 significantly integrated, are highly interdependent or highly interrelated, or 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, which may have previously qualified for separate accounting under legacy U.S. GAAP. Conversely, entities may be required to account for goods or services as separate performance obligations, which may have previously been accounted for as a combined deliverable under legacy U.S. GAAP.
1.6 Step 3: Determine the Transaction Price (Chapter 6 of the Roadmap)

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:

- **Variable consideration (see Section 6.3)** — When the transaction price includes a variable amount, an entity is generally 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 below). However, estimation may not be required in all circumstances. For example, variable consideration may not require estimation if it could be allocated entirely to a distinct good or service when certain criteria are met (see Section 1.7).

- **Significant financing components (see Section 6.4)** — Adjustments for the time value of money are required if the contract includes a “significant financing component” (as defined by the guidance).

- **Noncash consideration (see Section 6.5)** — 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 6.6)** — Like legacy U.S. GAAP, the new revenue standard 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 standard).

Some or all of an estimate of variable consideration is only included in the transaction price to the “extent that it is probable\(^3\) 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 guidance 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, a 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 (IP); 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 Section 12.7 for further discussion of the sales- or usage-based royalty exception for licenses of IP.

Under legacy 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 new revenue standard, however, 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 performance obligation 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. As a result, entities will most likely recognize revenue earlier under the new standard than they did under legacy U.S. GAAP.

\(^3\) 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.
Further, entities will need to exercise significant judgment when determining the amount of variable consideration to include in the transaction price and could therefore find it challenging to consistently apply the standard's requirements throughout their organizations.

**1.7 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 7.2).
- Allocating a discount to one or more, but not all, of the performance obligations in the contract (see Section 7.4).
- Allocating variable consideration to one or more, but not all, of the distinct goods or services in the contract (see Section 7.5).
- Allocating changes in the transaction price to the performance obligations in the contract (see Section 7.6).

Under the guidance, 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 guidance 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 guidance 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 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 variable consideration to one or more, but not all, of the performance obligations).

The guidance 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 new revenue standard's allocation guidance is similar to the legacy 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 vendor-specific objective evidence (VSOE) of fair value in accordance with ASC 985-605 may not be able to use a residual approach.
1.8  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).

Under the guidance, 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 guidance 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 faithfully depicts the transfer of goods or services to the customer. The new revenue standard provides specific guidance on measuring progress toward completion, including the use and application of output and input methods.

The guidance 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 guidance 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 guidance, 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:

• **Customer acceptance terms** (*Section 8.6.7*) — 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.

• **Consignment arrangements** (*Section 8.6.8*) — 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 8.6.9*) — The entity should evaluate whether control has passed to its customer (the new revenue standard provides specific criteria that are similar, but not identical, to legacy 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.

• **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.

### 1.9 Beyond the Core Model

The new revenue standard also affects other related accounting topics and creates new disclosure requirements, as discussed in Sections 1.9.1 and 1.9.2.
### 1.9.1 Other Related Accounting Topics

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

<table>
<thead>
<tr>
<th>Topic</th>
<th>Roadmap Chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Combination of contracts</strong></td>
<td>Chapter 4</td>
</tr>
<tr>
<td>There are certain circumstances in which multiple legal-form contracts would be accounted for as though they were one contract for accounting purposes. The new revenue standard provides guidance on when contracts should be combined.</td>
<td></td>
</tr>
<tr>
<td><strong>Rights of return</strong></td>
<td>Chapter 6</td>
</tr>
<tr>
<td>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.</td>
<td></td>
</tr>
<tr>
<td><strong>Customers’ unexercised rights</strong></td>
<td>Chapter 8</td>
</tr>
<tr>
<td>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.</td>
<td></td>
</tr>
<tr>
<td><strong>Contract modifications</strong></td>
<td>Chapter 9</td>
</tr>
<tr>
<td>The new revenue standard 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.</td>
<td></td>
</tr>
<tr>
<td><strong>Principal-versus-agent considerations</strong></td>
<td>Chapter 10</td>
</tr>
<tr>
<td>The new revenue standard moves away from a risks-and-rewards model and instead includes control-based 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.</td>
<td></td>
</tr>
<tr>
<td><strong>Licensing</strong></td>
<td>Chapter 12</td>
</tr>
<tr>
<td>The new revenue standard's guidance on licensing distinguishes between two types of licenses (right to use and right to access). The timing of revenue recognition is different for each.</td>
<td></td>
</tr>
<tr>
<td><strong>Costs of obtaining or fulfilling a contract</strong></td>
<td>Chapter 13</td>
</tr>
<tr>
<td>The new revenue standard 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 new revenue standard provides additional guidance on (1) determining an appropriate amortization period and (2) impairment considerations.</td>
<td></td>
</tr>
<tr>
<td><strong>Presentation</strong></td>
<td>Chapter 14</td>
</tr>
<tr>
<td>The new revenue standard includes guidance on the presentation of contract assets, contract liabilities, and receivables arising from contracts with customers.</td>
<td></td>
</tr>
<tr>
<td><strong>Nonpublic-entity requirements</strong></td>
<td>Chapter 17</td>
</tr>
<tr>
<td>The new revenue standard provides nonpublic entities with disclosure practical expedients and a delayed effective date.</td>
<td></td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Topic</th>
<th>Roadmap Chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonfinancial assets</td>
<td>Chapter 18</td>
</tr>
<tr>
<td>ASU 2014-09 (as amended by ASU 2017-05) 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).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income tax considerations</th>
<th>Chapter 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entities need to consider the income tax implications of applying the new revenue standard.</td>
<td></td>
</tr>
</tbody>
</table>

1.9.2 Required Disclosures (Chapter 15 of the Roadmap)

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 standard's disclosure requirements, which are significantly more comprehensive than those under legacy revenue guidance, include the following (there are certain exceptions for nonpublic entities; see Chapter 17 for a summary of these exceptions):

- Presentation or disclosure of revenue from contracts with customers and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts (e.g., leases).
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the standard 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 guidance).
The guidance 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 contract 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. For a summary of differences between U.S. GAAP and IFRS Standards, refer to Appendix A.

1.10 Effective Date (Chapter 16 of the Roadmap)

The effective date of the new revenue standard was deferred by one year when the FASB issued ASU 2015-14. As a result of the deferral, the new revenue standard is effective for public entities reporting under U.S. GAAP for annual reporting periods (including interim reporting periods within those annual periods) beginning after December 15, 2017, with early application permitted as of the standard's original effective date (i.e., reporting periods beginning after December 15, 2016).

For nonpublic entities reporting under U.S. GAAP, ASU 2015-14 provides that 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 (i.e., one year later than the dates originally prescribed for those entities), with early adoption permitted. In June 2020, the FASB issued ASU 2020-05 to further delay the effective date of the new revenue standard for certain nonpublic entities. See Chapter 17 for more information.

In a manner similar to that of other IFRS Standards, 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.

1.11 Transition Approach (Chapter 16 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 [the new revenue standard] 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 new revenue standard 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 legacy 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 new revenue standard 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 new revenue standard, including the financial statement line items and respective amounts directly affected by the standard’s application. The following chart illustrates the application of the new revenue standard and legacy revenue guidance under the modified retrospective method for a public entity with a calendar year-end:

<table>
<thead>
<tr>
<th>January 1, 2018</th>
<th>2018</th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Application Year</strong></td>
<td><strong>Current Year</strong></td>
<td><strong>Prior Year 1</strong></td>
<td><strong>Prior Year 2</strong></td>
</tr>
<tr>
<td>New contracts</td>
<td>New revenue standard</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Existing contracts</td>
<td>New revenue standard + cumulative catch-up</td>
<td>Legacy revenue guidance</td>
<td>Legacy revenue guidance</td>
</tr>
<tr>
<td>Completed contracts</td>
<td></td>
<td>Legacy revenue guidance</td>
<td>Legacy revenue guidance</td>
</tr>
</tbody>
</table>

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 the new revenue standard to determine whether a cumulative adjustment is necessary. Therefore, entities should consider 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.

The FASB 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 16 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 new revenue standard. 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 20.
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

Since the release of ASU 2014-09 (codified primarily in ASC 606) and IFRS 15, the FASB and IASB have issued amendments to the new revenue standard, some of which were discussed in public meetings of the boards or were identified by the TRG as possible standard-setting topics. Although no significant additional amendments are expected, 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 AICPA’s working groups, are engaging in ongoing discussions.

This Roadmap includes discussion of standard-setting and interpretive bodies’ various views on topics related to the new revenue standard. To provide additional insight, we have expanded our discussion of selected topics by adding paragraphs highlighted by the following symbols:

**Construction Ahead**

This symbol highlights topics on which stakeholders (e.g., standard-setting and regulatory bodies such as the FASB and SEC) have proposed changes to guidance that is relevant to accounting for revenue from contracts with customers.

**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 legacy practices.

**Connecting the Dots**

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.
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 14), 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 IFRS Standards.

The terms and definitions below are reproduced from the ASC 606 glossary.

<table>
<thead>
<tr>
<th><strong>ASC 606-10 — Glossary</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract</strong></td>
</tr>
<tr>
<td>An agreement between two or more parties that creates enforceable rights and obligations.</td>
</tr>
<tr>
<td><strong>Contract Asset</strong></td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td><strong>Contract Liability</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Customer</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Lease (ASC 840)</strong></td>
</tr>
<tr>
<td>An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.</td>
</tr>
<tr>
<td><strong>Lease (ASC 842)</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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
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 notes) 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.

Security
A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

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 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
3.1.1 Meeting the Objective
3.1.2 Applying the New Standard

3.2 Scope
3.2.1 In General
3.2.2 Guarantees
3.2.3 Contributions
3.2.4 Nonmonetary Transaction Between Entities in the Same Line of Business
3.2.5 Barter Credit Transactions
3.2.6 Fixed-Odds Wagering Contracts
3.2.7 Scope of Guidance on Contract Costs
3.2.8 Determining the Customer in a Contract
3.2.9 Collaborative Arrangements
3.2.10 Contracts That Include Both Revenue and Nonrevenue Elements
3.2.11 Contracts That Pose Scope Challenges
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 entities, 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 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” — 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’s projects 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:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
<th>Meeting the Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-2</td>
<td>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.</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>When?</th>
<th>The entity satisfies a performance obligation by transferring a good or service to the customer.</th>
</tr>
</thead>
<tbody>
<tr>
<td>How much?</td>
<td>Amount to which the entity expects to be entitled (i.e., transaction price) allocated to the distinct goods or services.</td>
</tr>
</tbody>
</table>

### 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, legacy revenue practices often precluded the entity from recognizing revenue when performance occurred, including when (1) revenue was contingent on future events (e.g., not fixed or determinable) or (2) VSOE of fair value was 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 12 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 6.4.4).

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.”

Connecting the Dots — 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 legacy 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 21 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 15 for further discussion).

Changing Lanes — From Risks and Rewards to a Control Model

Much of legacy 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 recognizes revenue when it determines that its customer has obtained control of an asset on the basis of the customer's ability to direct the use of, and 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.

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 presented as follows:

- **Recognition** — Step 1 (identify the contract), step 2 (identify the 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 (allocate the transaction price to the performance obligations in the contract).

An entity should consider all five steps for every contract with a customer unless a step is clearly inapplicable. After considering the specific facts and circumstances of a particular contract and understanding the framework and the five steps, an entity may find that one of the steps is not relevant. For example, when an entity determines in step 2 that a contract contains only a single performance obligation, step 4 (allocation of the transaction price) will often not be applicable. In such a case, the entity can, in effect, jump from step 3 to step 5.

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 or concurrently with applying an earlier one.

### Example 3-1

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 the 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 (determine 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 3-2

Under step 2 (identify 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 for determining how revenue is recognized. As a result, an entity would need to understand and make a determination about step 5 before applying step 2.
Example 3-3

To determine the transaction price in step 3, an entity is required to identify, estimate, and potentially constrain variable consideration in accordance with ASC 606-10-32-11 through 32-13. The consideration in a contract may vary as a result of many different factors, including when the price is a fixed rate per increment of service (e.g., hours) but the expected increments of service may vary throughout the contract term. In this situation, step 3 would require an entity to estimate the increments of service expected to be provided over the contract term since such increments would result in variable consideration that the entity would need to estimate (and potentially constrain) when determining the transaction price. Step 4 would require the transaction price to be allocated to the distinct goods or services identified in the contract on the basis of their relative stand-alone selling prices, and the entity would need to determine when (or how) the performance obligation is satisfied as part of step 5, under which it would need to select a single measure of progress to determine how control of the promised services is transferred to the customer over time. However, if the promise to provide services qualifies as a series (which would be accounted for as a single performance obligation), ASC 606-10-55-18 provides a practical expedient that allows an entity that is recognizing revenue over time by using an output method to recognize revenue equal to the amount that the entity has the right to invoice if the invoiced amount corresponds directly to the value transferred to the customer.

If the amount that the entity is able to invoice corresponds directly to the value transferred to the customer (e.g., the invoiced amount is determined on the basis of hours of service provided and a rate per hour that corresponds to the value of the services), the entity can recognize revenue in the amount that it is entitled to bill. Thus, the entity effectively combines steps 3, 4, and 5 when it determines that it can apply the practical expedient in ASC 606-10-55-18.

3.1.2.1 Applying the Guidance Consistently to Contracts With Similar Characteristics and in Similar Circumstances

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) provides that if 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 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

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10-4</strong> 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.</td>
</tr>
</tbody>
</table>

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.”

3.1.2.2.1 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.

An entity in this situation may want to use a portfolio approach as a practical expedient in accordance with ASC 606-10-10-4. 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.
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 factors 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.

<table>
<thead>
<tr>
<th>Objective Factors</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract deliverables</td>
<td>Mix of products and services; options to acquire additional goods and services; warranties; promotional programs</td>
</tr>
<tr>
<td>Contract duration</td>
<td>Short-term, long-term, committed, or expected term of contract</td>
</tr>
<tr>
<td>Terms and conditions of the contract</td>
<td>Rights of return, shipping terms, bill and hold, consignment, cancellation privileges, and other similar clauses</td>
</tr>
<tr>
<td>Amount, form, and timing of consideration</td>
<td>Fixed, time and material, variable, up-front fees, noncash, significant financing component</td>
</tr>
<tr>
<td>Characteristics of the customers</td>
<td>Size, type, creditworthiness, geographic location</td>
</tr>
<tr>
<td>Characteristics of the entity</td>
<td>Volume of contracts that include the various characteristics; historical information available</td>
</tr>
<tr>
<td>Timing of transfer of goods or services</td>
<td>Over time; at a point in time</td>
</tr>
</tbody>
</table>
The example below illustrates how such factors may be applied.

**Example 3-4**

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.

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

* 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: \[\frac{250}{250 + 960} \times 960 = 198\]

Customer B: \[\frac{250}{250 + 1,440} \times 1,440 = 213\]

Customer C: \[\frac{500}{500 + 960} \times 1,160 = 397\]

Customer D: \[\frac{500}{500 + 1,440} \times 1,640 = 423\]

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 factors 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" 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.

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.

### 3.1.2.2.2 Applying the Portfolio Approach to Some, but Not Other, Similar Contracts

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, 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. Example 3-5 below illustrates a situation in which it is acceptable for an entity to apply the portfolio approach to some contracts and not apply it to others.

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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.”
Example 3-5

Assume the following facts:

- Entity A consolidates Subsidiary B and Subsidiary C, both of which have a large number of contracts with customers with similar characteristics.
- Subsidiary B has 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.
- Subsidiary C 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.

In its consolidated financial statements, A may apply a portfolio approach to contracts with B’s customers without applying that approach to contracts with C’s customers if it reasonably expects that the use of that approach would not differ materially from applying ASC 606 on a contract-by-contract basis. In these circumstances, B and C are materially applying the same accounting policy to A’s revenue contracts that have similar characteristics.

Connecting the Dots — 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. Q&A 39 of the FASB’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”) specifies 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 6.3.2 for the FASB staff’s conclusion, and refer to Chapter 21 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

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entities</td>
</tr>
<tr>
<td>15-1 The guidance in this Subtopic applies to all entities.</td>
</tr>
</tbody>
</table>
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.
  b. 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
  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.

Pending Content (Transition Guidance: ASC 842-10-65-2)

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. 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 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
  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.
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 refer to the AICPA industry task forces’ interpretive guidance, which can be used as a resource to promote consistency among preparers. In addition, companies can contact the OCA for help in addressing implementation questions. Refer to Chapter 20 for recent 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 3.2.10 for further details.
Account for it under ASC 840 (or ASC 842).²

Is it a lease?

Yes

Account for it under ASC 944.

No

Is it a contract within the scope of ASC 944?

Yes

Is it for the sale of a nonfinancial asset?

Yes

Account for it under ASC 610-20.

No

Is it a financial instrument?

Yes

Account for it under ASC 606.

No

Is it a guarantee (and not a warranty)?

Yes

Account for it under ASC 845.

No

Is it with a customer?

Yes

Account for it under other applicable U.S. GAAP by applying relevant financial instruments guidance (e.g., ASC 815, ASC 320).

No

Is it a nonmonetary exchange that facilitates a sale to another party?

Yes

Account for it under other applicable U.S. GAAP.

No

Does the entity have a contract?

Yes

Account for it under other applicable U.S. GAAP.

No

Start

² See Section 16.2.5 for a discussion of scope considerations related to contracts accounted for under both ASC 606 and ASC 840 (or ASC 842).
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 (i.e., accounted for in accordance with ASC 840 or ASC 842) or a financing (i.e., accounted for in accordance with ASC 606-10-55-70). 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.

3.2.2 Guarantees

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

Connecting the Dots — No Separate Scope Exclusion in IFRS 15 for Guarantees

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.

3.2.2.1 Performance Guarantees

Typically, performance guarantees would be outside 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. Therefore, performance guarantees would typically be accounted for as a form of variable consideration within the scope of ASC 606.

Example 3-6

Entity X has entered into 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, X will have to pay the customer $1 million.

This service level guarantee is not within the scope of ASC 460 because it is guaranteeing X’s own future performance under the contract. 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.

3.2.2.2 Profit Margin Guarantees

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) or, in certain circumstances, 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.
Example 3-7

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 if the retailer has not met a minimum sales margin (i.e., a profit margin guarantee). 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 does 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.

3.2.3 Contributions

Contributions are not within the scope of ASC 606. The ASC master glossary (as amended by ASU 2018-08) defines a contribution as follows:

An unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, 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 commensurate value
- Investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners
- Other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers.

In a contribution transaction, the resource provider often receives value indirectly by providing a societal benefit although that benefit is not considered to be of commensurate value. In an exchange transaction, the potential public benefits are secondary to the potential direct 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] and [the ASC master glossary’s definition of a conditional 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).

In June 2018, the FASB issued ASU 2018-08, which amends certain aspects of the guidance to clarify the scope and accounting for contributions received and contributions made. As part of these clarifications, ASU 2018-08 amends ASC 606 to include the guidance in ASC 606-10-15-2A, which states:

An entity shall consider the guidance in Subtopic 958-605 on not-for-profit entities — revenue recognition — contributions when determining whether a transaction is a contribution within the scope of Subtopic 958-605 or a transaction within the scope of [ASC 606].

As explained in paragraph BC28 of ASU 2014-09, ASC 606 applies to only a subset of revenue — specifically, revenue from contracts with customers. Therefore, because contributions 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 that is an exchange transaction) and the counterparty to the transaction is a customer, such a reciprocal transfer should be accounted for under ASC 606.
Chapter 3 — Objective and Scope

The above issue is addressed in Implementation Q&A 6 (compiled from previously issued TRG Agenda Papers 26 and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

### 3.2.4 Nonmonetary Transaction Between Entities in the Same Line of Business

An entity is not permitted to 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. ASC 606-10-15-2(e) states that an example of such a nonmonetary transaction is “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.”

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.

Questions have arisen about what constitutes the “same line of business” under the scope exception in ASC 606-10-15-2(e). We generally believe that entities are in the same line of business when they are undertaking similar activities or operations, as opposed to only being in the same industry or sector. In determining whether entities are undertaking similar activities or operations, an entity should use judgment and consider factors such as (1) the nature of the activities being performed, (2) the nature of the items being exchanged, and (3) the purpose of the exchange.

In addition, if two entities in the same line of business are exchanging inventories, we believe that for the inventories to qualify for the nonmonetary exchange scope exception (i.e., measurement based on the carrying amount of the inventory transferred in accordance with ASC 845-10-30-16), the exchange should be of like-kind inventory for like-kind inventory (i.e., raw materials or work-in-process inventory exchanged for raw materials, work-in-process, or finished goods inventory; or finished goods inventory exchanged for finished goods inventory) and should be to facilitate sales to end customers. Accordingly, it would generally not be appropriate for an entity to apply the scope exception in ASC 606-10-15-2(e) if it is exchanging finished goods inventory for another entity’s raw materials or work-in-process inventory regardless of whether the entities are in the same line of business.

### 3.2.5 Barter Credit Transactions

In some industries, entities may enter into arrangements referred to as “barter credit transactions.” Barter credit transactions may occur in many forms. In one common form, an entity provides goods or services and in return receives “credits” that can be used for a specific period to acquire products or services from either (1) a specific company that is a party to the exchange of products or services or (2) members of a “barter” exchange network. Barter exchange networks allow one member to exchange products or services of another member even if the member providing the products or services was not the counterparty to the original barter contribution. Barter credit transactions are structured in various ways and may differ significantly in terms of business motives or levels of risk.
Barter credit transactions may include exchanges of items such as the following:

- Products or services for advertising credits.
- Professional services for travel credits.
- Air travel or other vacation travel for advertising credits.

Although barter credit transactions may create opportunities for barter participants, they pose various risks principally related to the measurement of the transaction, including:

- Failure to recognize impairment in value of products given up in a barter transaction.
- Difficulties in converting products or credits received in a barter transaction to cash when no market for the products or credits exists.
- Expiration of unused barter credits.
- Inadequate internal controls over barter credits.
- Inability to acquire products or services in return that are worth as much as the products or services contributed.
- Inability to reasonably determine the value of products or services received in return.

Since barter credit transactions are akin to nonmonetary exchanges, entities should consider whether particular barter credit transactions are subject to the scope exception for nonmonetary exchanges in ASC 606-10-15-2(e).

In accordance with ASC 606-10-15-2(e), nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers are outside the scope of ASC 606 and may be subject to the guidance in ASC 845 on nonmonetary transactions. Typically, no revenue is recognized when the guidance in ASC 845 is applied to such nonmonetary exchanges outside the scope of ASC 606.

Accordingly, for an entity to determine whether a barter credit transaction should be accounted for under ASC 606 or under ASC 845, the entity should understand the substance and purpose of the barter credit transaction. If the entity determines that the barter credit transaction represents a contract with a customer that is within the scope of ASC 606, it should account for the barter credits received from the customer as noncash consideration, as discussed in Section 6.5.2.

### 3.2.6 Fixed-Odds Wagering Contracts

Fixed-odds wagers are wagers placed by bettors (i.e., customers) who typically know the odds of winning in gaming activities at the time the bets are placed with gaming industry entities. Under legacy 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, the new revenue standard eliminates the guidance in ASC 924-605 and does not apply to contracts accounted for as derivatives under ASC 815.

In addition, stakeholders referred to an issue that the IFRS Interpretations Committee considered adding to its agenda in 2007, regarding which it noted (in an agenda decision reported in the July 2007 IFRIC Update) that an unsettled wager is a financial instrument that is likely to meet the definition of a derivative financial instrument under IAS 39. Partly because of the new revenue standard's elimination of ASC 924-605 and partly because of the comments that the IFRS Interpretations Committee made in its 2007 agenda decision, stakeholders reporting under U.S. GAAP questioned whether fixed-

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3. Common gaming activities include table games, slot machines, keno, bingo, and sports and race betting.
4. Currently, an entity that is required to adopt IFRS 9 should apply IFRS 9 rather than IAS 39 when accounting for derivatives.
odds wagering 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 (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 believed that the Board intended 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.”

In December 2016, the FASB issued ASU 2016-20 on technical corrections to the new revenue standard, which includes a derivatives guidance scope exception for fixed-odds wagering contracts in ASC 924 by adding a new Codification subtopic (ASC 924-815, Entertainment — Casinos: Derivatives and Hedging) that clarifies that such contracts are revenue contracts within the scope of ASC 606.

### 3.2.7 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 13.

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

<table>
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<th>ASC 606-10</th>
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<td><strong>15-5</strong> 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.</td>
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In certain industries, most notably the automotive supplier and aerospace and defense industries, an entity will incur costs related to activities it performed before producing a good for a customer. Sometimes, an entity may incur costs for these activities before executing a contract with a customer and may even be entitled to consideration from the potential customer in connection with the initial activities. An entity may be willing to incur such costs (even in excess of amounts due from the potential customer) because of an expectation, based on current negotiations or on perceived customer demand for the product, that a contract will be executed in the near term. Costs incurred are typically related to engineering, design, and development activities, along with the manufacturing or purchase of specific equipment, molds, tools, or dies that will be used to produce the good.

Under legacy U.S. GAAP, the accounting for these types of costs (and associated consideration received from the potential customer) varies across industries and within the same industry. With the introduction of the new cost guidance in ASC 340-40, stakeholders have questioned whether these sorts of preproduction costs would be within the scope of ASC 340-40 and would therefore need to be assessed for capitalization under the criteria in ASC 340-40-25-5. The cost guidance in ASC 340-40 applies to costs incurred to fulfill a contract with a customer within the scope of ASC 606, noting that the costs could be related to an anticipated contract with a customer. Therefore, in evaluating whether these preproduction costs should be accounted for under ASC 340-40, an entity will need to determine whether the costs in question are incurred in connection with a contract (or anticipated contract) that is within the scope of ASC 606. An entity may need to use judgment when determining whether the preproduction activities are within the scope of ASC 606 because (1) the preproduction activities transfer a good or service to a customer that is part of the entity’s ordinary activities or (2) the costs are fulfillment costs incurred in connection with an anticipated contract with a customer.

The above issue is addressed in Implementation Q&A 66 (compiled from previously issued TRG Agenda Papers 46 and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C. See also Section 13.3.4.

As a result of questions raised by stakeholders and diversity in practice under legacy U.S. GAAP, the FASB instructed its staff to conduct outreach to various stakeholders to better understand how existing practice developed and what, if any, additional education would help stakeholders determine how to apply the new guidance in ASC 606 and ASC 340-40. At the February 15, 2017, FASB meeting, the FASB staff reported to the Board the results of its outreach. In the handout for the meeting, the staff included a decision tree to help stakeholders evaluate whether preproduction activities are within the scope of ASC 606 and ASC 340-40. The decision tree is reproduced below.
Although the FASB provided some interpretative guidance in the form of the February 2017 Board meeting handout (illustrated above), stakeholders (particularly in the automotive supplier industry) continued to raise questions about the appropriate guidance to apply to account for preproduction costs and related reimbursements. Specifically, stakeholders in the automotive industry questioned whether diversity in practice would continue to be appropriate upon the adoption of ASC 606 and ASC 340-40. On the basis of discussions with the SEC staff after the February 2017 FASB meeting, we understand that some diversity in practice will continue to be acceptable depending on the facts and circumstances and an entity’s historical conclusions about scope. Specific considerations related to accounting for preproduction costs and related reimbursements in the automotive supplier industry are as follows:

- Automotive suppliers that historically concluded that their preproduction costs were within the scope of ASC 340-10 should continue to apply that guidance upon adoption of the new revenue standard. Automotive suppliers that historically applied the guidance in ASC 340-10 by analogy should evaluate their preproduction costs under the fulfillment cost guidance in ASC 340-40 upon adoption of the new revenue standard.

- Diversity in practice will continue to be acceptable for accounting for reimbursements received from original equipment manufacturers for a supplier’s preproduction activities. If a supplier historically accounted for the reimbursements as revenue under ASC 605, it would most likely be acceptable for the supplier to continue to account for the reimbursements as revenue under ASC 606. Similarly, if a supplier historically accounted for the reimbursements as an offset to the related costs (i.e., not revenue), this practice would continue to be acceptable upon the adoption

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5 “For example, the activities do not constitute an entity's ongoing major or central operations (Master Glossary — Revenue).”
6 “This may result in the reimbursement being recorded as other income or as contra-expense.”
7 “If the NRE and the subsequent production units are in a single contract or the contracts meet the criteria for contract combination in paragraph 606-10-25-9, this may result in revenue being recognized over a period longer than the preproduction period. For example, it may result in revenue being recognized over subsequent production units.”
of the new revenue standard. The resulting policy should be consistent with the principles of ASC 606 and related discussion of the TRG in November 2015 (see Implementation Q&A 65 [compiled from previously issued TRG Agenda Papers 46 and 49]).

- If a supplier would like to change its accounting policy for reimbursements received for preproduction activities, further analysis may be required. We generally believe that a supplier should consider consulting with the SEC staff if the supplier believes that a change in its accounting policy for reimbursements for preproduction activities (i.e., a change from revenue to cost reimbursement, or a change from cost reimbursement to revenue) is warranted under ASC 606.

This topic was addressed by Joseph Epstein, then professional accounting fellow in the OCA, in a speech at the 2017 AICPA Conference on Current SEC and PCAOB Developments. In his speech, Mr. Epstein acknowledged that the SEC staff was engaged in a prefiling consultation with an SEC registrant regarding the accounting for a preproduction arrangement. Mr. Epstein further noted that the SEC staff did not object to the following conclusions reached by the registrant (footnotes omitted):

- The “design activities did not transfer control of a good or service to the counterparty, and therefore were not a performance obligation under Topic 606, because the periodic information provided to the counterparty related to the design activities over the course of the arrangement was not detailed enough to enable the counterparty to avoid having to re-perform the design work, for example, if the design efforts were not successful or if the counterparty selected another manufacturer for the specialized good.”

- The “pre-production design activities should be accounted for as research and development expenses and . . . payments received should be accounted for as an advance payment for the future sale of the specialized good to the counterparty.”

- It was appropriate to treat the change in accounting for a preproduction arrangement as part of the registrant’s transition to ASC 606 rather than as a voluntary change in accounting principle under ASC 250.

Mr. Epstein also noted that the SEC staff would not object if registrants that have historically accounted for preproduction activities as nonrevenue arrangements continue to apply their nonrevenue models to preproduction arrangements after adoption of the new revenue standard. However, he encouraged such registrants to consult with the OCA if they are considering either the application of a revenue model under ASC 606 or changes to their historical nonrevenue models.

### 3.2.8 Determining the Customer in a Contract

<table>
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<td><strong>15-3</strong> 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.</td>
</tr>
</tbody>
</table>
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.

As noted in the Background Information and 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.” 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.

Connecting the Dots — 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 18.

Connecting the Dots — Contracts With Another Entity That Is Both a Customer and a Vendor

In certain arrangements, an entity may enter into one or more contracts with another entity that is both a customer and a vendor. That is, the reporting entity may enter into one or more contracts with another entity to (1) sell goods or services that are an output of the reporting entity’s ordinary activities in exchange for consideration from the other entity and (2) purchase goods or services from the other entity.

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8 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.”

9 The ASC master glossary defines a vendor as a “service provider or product seller, such as a manufacturer, distributor, or reseller.”
In these types of arrangements, the reporting entity will need to use judgment to determine whether the other entity is predominantly a customer or predominantly a vendor. It may not be possible to make this determination solely on the basis of the contractual terms. In such cases, the reporting entity will need to consider the facts and circumstances of the overall arrangement with the other entity. The reporting entity’s conclusion that the other entity in the arrangement is predominantly a customer or predominantly a vendor may determine whether (1) the consideration received from the other entity should be accounted for under ASC 705-20 as consideration received from a vendor or (2) the consideration paid to the other entity should be accounted for under ASC 606 as consideration payable to a customer.

Applying the guidance on consideration payable to a customer and consideration received from a vendor is further discussed in Sections 6.6.2 and 6.6.2.5, respectively.

3.2.9 Collaborative Arrangements

Companies often enter into arrangements with third parties for the development or commercialization of goods and services in an effort to share in both the costs and risks associated with such activities. When an entity enters into a collaboration, management must consider whether the arrangement meets the U.S. GAAP definition of a collaborative arrangement to determine whether the arrangement is subject to the requirements of ASC 808. The legal characterization of an arrangement (e.g., as a collaboration or a collaborative arrangement) does not necessarily make the arrangement qualify as a collaborative arrangement under U.S. GAAP.

ASC 808-10-20 defines a collaborative arrangement as a “contractual arrangement that involves a joint operating activity” and involves two (or more) parties that are both of the following:

- “[A]ctive participants in the activity.”
- “[E]xposed to significant risks and rewards dependent on the commercial success of the activity.”

On the basis of these criteria, some types of collaborations may not meet the definition of a collaborative arrangement and therefore would not be within the scope of ASC 808. For example, certain arrangements in which one party solely provides financial resources for an endeavor and is generally not an active participant would not meet the definition of a collaborative arrangement. Alternatively, arrangements between two parties that involve codevelopment, comarketing, or copromotion activities, as well as the sharing of risks and rewards based on the success of such activities, would generally meet the definition of a collaborative arrangement.

A collaboration can begin at any point in the life cycle of an endeavor (e.g., during the research and development (R&D) phase or after a product has been commercially launched). The facts and circumstances associated with the arrangement will dictate whether the parties (1) represent active participants and (2) are exposed to significant risks and rewards.

ASC 808-10-15-8 cites the following examples of situations in which active participation may exist:

a. Directing and carrying out the activities of the joint operating activity
b. Participating on a steering committee or other oversight or governance mechanism
c. Holding a contractual or other legal right to the underlying intellectual property.
In addition, ASC 808-10-15-11 lists circumstances that might indicate that participants are not exposed to significant risks and rewards:

- Services are performed in exchange for fees paid at market rates.
- A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
- Initial profits are allocated to only one participant.
- There is a limit on the reward that accrues to a participant.

Further, in accordance with ASC 808-10-15-12, an entity should also consider other factors when evaluating participants’ exposure to significant risks and rewards, including (1) the “stage of the endeavor’s life cycle” and (2) the “expected duration or extent of the participants’ financial participation . . . in relation to the endeavor’s total expected life or total expected value.”

A collaborative arrangement may, in whole or in part, represent a contract with a customer that should be accounted for under ASC 606. The Background Information and Basis for Conclusions of ASU 2014-09 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:

- 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.
- 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.
- 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 3-8**

| Biotech B and Pharma P enter into an agreement to research, develop, and commercialize drug X. Biotech B will perform the R&D, 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 the collaborative agreement or other contracts between the two entities. 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. |

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 November 2018, the FASB issued ASU 2018-18, which contains targeted improvements to the guidance on collaborative arrangements in ASC 808, including the following clarifications:

- In the evaluation of whether a transaction in a collaborative arrangement is within the scope of ASC 606, the unit of account is a distinct good or service.
- When the collaborative participant is a customer, the recognition, measurement, presentation, and disclosure requirements of ASC 606 should be applied to the transaction.
- An entity in a collaborative arrangement is precluded from presenting a transaction as revenue if the collaborative participant counterparty is not a customer.

While the amendments in ASU 2018-18 primarily affect the guidance in ASC 808, the ASU also amends ASC 606-10-15-3 to remove the following guidance:

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.

ASU 2018-18 is effective for public business entities (PBEs) for fiscal years beginning after December 15, 2019, including interim periods therein. Early adoption is permitted for PBEs for periods (including interim periods) for which financial statements have not yet been issued; however, an entity may not adopt ASU 2018-18 earlier than its date of adoption of ASC 606. The amendments in ASU 2018-18 should be applied retrospectively to the date of initial application of ASC 606, with a cumulative-effect adjustment recognized in the entity's opening balance of retained earnings as of the later of (1) the earliest period presented or (2) the period that includes the date of the entity's initial application of ASC 606.

For more information, see Deloitte's November 13, 2018, Heads Up.

### 3.2.10 Contracts That Include Both Revenue and Nonrevenue Elements

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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. For example, if a contract includes performance obligations subject to ASC 606 and a guarantee subject to ASC 460 (e.g., an indirect guarantee of the indebtedness of others), the guarantee would typically be recognized at its fair value, with the residual transaction price recognized under ASC 606.

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 an entity that enters into a single contract to lease a boat to a customer and provide cleaning services for that boat. Assume that the entity 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 entity has adopted both the new revenue standard and the new leasing standard and that the entity has not elected to use the available practical expedient that would allow it to avoid separating lease and nonlease components (see Section 16.2.5.2). In accordance with ASC 606, the entity would first look to the other guidance (the leasing 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 entity would apply the allocation guidance in ASC 606. In this situation, the leasing standard says to apply the allocation guidance in ASC 606. Therefore, the entity 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.

### 3.2.11 Contracts That Pose Scope Challenges

Some contracts may 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.

#### 3.2.11.1 Lapsed Unexercised Warrants

Entities often issue warrants (options issued on the entity’s own shares) for cash. If these warrants meet the definition of equity instruments under ASC 815-40, the amount received for issuing them is credited to equity. When the warrants lapse unexercised, revenue should not be recognized. The issuance of warrants for cash is not a transaction with customers; rather, it is a transaction with equity participants. The definition of comprehensive income (which encompasses both revenue and gains in accordance with the conceptual framework) excludes contributions from 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.

#### 3.2.11.2 Incentive-Based Capital Allocation Arrangements

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, a private-equity or real estate fund manager (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 the fund’s limited partnership interests (commonly referred to as “carried interests”).
One common arrangement is referred to as “2 and 20” (i.e., 2 percent and 20 percent). The 2 percent refers to an annual management fee computed on the basis of assets under management. Management fees are generally separate and distinct from performance-based capital allocations since management fees are usually in the form of a cash-based contractual relationship between the asset manager and the fund. Therefore, management fees would be subject to ASC 606.

The 20 percent refers to a term in a performance fee arrangement under which the asset manager participates in a specified percentage (e.g., 20 percent) of returns after other investors have achieved a specified return on their investments, which is referred to as a hurdle rate (e.g., 8 percent).

Under a prevalent form of such an arrangement, the performance fee is in the legal form of a capital account within the equity structure of the fund, or “carried interest.” As noted above, the asset manager’s capital account receives allocations of the returns of a fund when those returns exceed predetermined thresholds. In addition to the carried interest, the asset manager or affiliates often acquire a small ownership interest in the fund through general partner or limited partner interests on the same basis as other investors. Such interests receive only pro rata allocations of fund returns and are not typically subject to the accounting guidance in ASC 606 since there are no incentive or performance aspects to the arrangement.

In other cases, the fund manager’s performance fee may be in the form of a contractual arrangement with the fund rather than an allocation of capital within an equity interest.

Under legacy revenue guidance, companies with incentive-based capital allocation arrangements generally applied the guidance in EITF Topic D-96 (codified in ASC 605-20-599-1), which specifies two acceptable methods of accounting for the receipt of performance-based fees:

- **Method 1** — Because fees that the fund manager earned by exceeding performance targets early in the measurement period may be reversed if performance targets are missed later in the measurement period, no incentive fee income is recorded until the end of the measurement period (which may sometimes be coterminal with the life of the fund under management).

- **Method 2** — Incentive fee income is recorded on the basis of the amount that would be due under the relevant formula at any point in time as if the contract were terminated at that date. This method also allows entities to recognize revenue in periods before the end of the underlying fund’s life on the basis of the amount that would be due if the fund were liquidated at that interim date.

However, EITF Topic D-96 also acknowledged that some general partners receive fees in the form of partnership allocations and that those entities could also account for such incentive-based capital allocation arrangements under the equity method in ASC 323.

Under the new revenue standard, the incentive fee portion of an asset management arrangement is likely to represent variable consideration, as discussed further below. As illustrated in Example 25 of the new standard (ASC 606-10-55-221 through 55-225), the application of the variable consideration constraint may result in a delay in recognition of incentive fees for entities that previously chose to apply Method 2. In some cases, this delay may be significant.
Chapter 3 — Objective and Scope

3.2.11.2.1 Views Proposed by Stakeholders

While Example 25 of the new revenue standard contains implementation guidance that demonstrates how to apply the variable consideration constraint to an asset management contract, “the example does not state that the form of the incentive fee is a capital allocation or cash (or some other asset).”\(^{10}\) That is, Example 25 does not specify whether it “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).”\(^{11}\) Consequently, stakeholders have expressed the following views 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 “are ownership interests and should be accounted for under other GAAP”\(^{12}\) 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.

At the TRG meeting in April 2016, 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.

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 consideration 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.\(^{13}\)

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10 Quoted from Implementation Q&A 3 (compiled from previously issued TRG Agenda Papers 50 and 55).
11 Quoted from paragraph 12 of TRG Agenda Paper 50.
12 See footnote 10.
13 Q&A 3 of the FASB Staff Implementation Q&As summarizes the views presented by the TRG members at the TRG’s April 2016 meeting and states that “[t]he [FASB] staff’s view is that incentive-based capital allocations are within the scope of Topic 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 Implementation Q&A 3 as follows:

The SEC staff observer at the TRG meeting indicated that he anticipates the SEC staff would accept an application of Topic 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 Topic 810, the equity method of accounting under Topic 323, or other relevant guidance.

We believe that an entity contemplating the ownership model view under ASC 323 should consider consulting with its accounting advisers and auditors.

The minutes of the TRG meeting (TRG Agenda Paper 55) suggest that the FASB staff does not recommend that the Board undertake standard-setting activity with respect to this topic.

### 3.2.11.2.2 Acceptable Views

We believe that there are two acceptable views (“View 1” and “View 2”) on whether carried interests are within the scope of ASC 606:

- **View 1** — Carried interests are within the scope of the new revenue standard.
- **View 2** — Carried interests may be outside the scope of the new revenue standard depending on the nature and substance of the arrangement.

View 1 was supported by all seven FASB board members at the April 2016 FASB-only TRG meeting. 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). At the same meeting, the SEC staff observer indicated that he anticipates that the SEC staff would find it acceptable to apply ASC 606 to such arrangements (i.e., View 1 could be acceptable).

However, the SEC staff observer also noted that there may be a basis for using an ownership model such as that in ASC 323 (i.e., View 2 could be acceptable). Specifically, certain entities may be able to demonstrate that their incentive-based capital allocation arrangements that involve an equity interest are financial instruments within the scope of other U.S. GAAP, particularly ASC 323. In such cases, these arrangements would qualify for the following scope exception in ASC 606-10-15-2(c):

- **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 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
Entities should carefully evaluate the scope guidance in these ASC topics to determine whether their incentive-based capital allocation arrangements can be accounted for under ASC 323. Entities should consider the nature and legal form of such arrangements — specifically, whether the incentive fee is an attribute of an equity interest in the fund (e.g., a disproportionate allocation of fund returns to a capital account owned by the manager).

When the incentive fee is not an allocation of fund returns among holders of equity interests (e.g., when the fee is in the form of a contractual arrangement with the fund), it should be accounted for under ASC 606.

In addition, we understand that it is customary industry practice for entities to use incentive-based capital allocation arrangements if they were to reach a conclusion that such arrangements are subject to the guidance in ASC 323.

We believe that under View 2, there are two acceptable approaches that an entity can use to present carried interest arrangements in its statement of performance:

- **Approach A: present within revenue** — Proponents of this approach believe that incentive fees in carried interest arrangements continue to represent revenue\(^\text{14}\) earned by an entity and should therefore be presented within revenue. However, since these revenues are outside the scope of the new revenue standard, they should not be labeled as (or be under a caption related to items that include) revenue from contracts with customers in an entity’s financial statements or in the accompanying footnotes and disclosures. If an entity has one or more captions related to revenue from customers, a separate, appropriately labeled caption would be necessary.

- **Approach B: present outside of revenue** — Proponents of this approach believe that since incentive fees in carried interest arrangements are derived from an entity’s investment in equity method investees, they should be presented within the earnings of the entity’s equity method investee(s) in the statement of performance.

### Connecting the Dots — Accounting Policy Choice for Recognition and Presentation of Carried Interest Arrangements

If an entity determines that fees under carried interest arrangements may be accounted for outside of ASC 606, we would encourage the entity to consult with accounting advisers regarding the nature and legal form of those arrangements. On the basis of informal discussions with the SEC staff, we understand that the staff would not object to a conclusion that carried interests in the form of incentive-based capital allocation arrangements may be accounted for within the scope of either ASC 606 or ASC 323 (if the considerations described above are met), and that this is an accounting policy choice that should be made when EITF Topic D-96 is rescinded upon the adoption of ASC 606. Further, from a performance statement perspective, the SEC staff would not object to the presentation of performance-based capital allocation fees in accordance with either Approach A or Approach B as described above.

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\(^{14}\) The definition of revenue remains unchanged from that in paragraph 78 of FASB Concepts Statement 6, which states that “[r]evenues 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.”
3.2.11.3 **Financial Institution Transactions**

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\(^{15}\) should be accounted for under ASC 860, (2) deposit-related fees\(^{16}\) should be accounted for under ASC 405, (3) fees from financial guarantees\(^{17}\) should be accounted for under ASC 460 or ASC 815, and (4) rights and obligations under a credit card issuing bank's contract as well as the corresponding reward program should be accounted for under ASC 310. These matters were discussed at the July 2015 and April 2016 TRG meetings, and the TRG generally agreed with the FASB staff's analysis and conclusions.

3.2.11.3.1 **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 staff believes that servicing arrangements within the scope of ASC 860 are outside 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, entities should apply the guidance in ASC 860 to account for such cash flows.\(^{18}\)

The above issue is addressed in Implementation Q&A 4 (compiled from previously issued TRG Agenda Papers 52 and 55). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

3.2.11.3.2 **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 legacy SEC revenue guidance (SAB Topic 13) 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

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\(^{15}\) 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.

\(^{16}\) 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).

\(^{17}\) 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.

\(^{18}\) As noted by the FASB staff, 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).
would be similar regardless of the number of performance obligations identified, and any changes to legacy practice would most likely be insignificant.

The above issue is addressed in Implementation Q&A 5 (compiled from previously issued TRG Agenda Papers 52 and 55). For additional information and Deloitte's summary of the Implementation Q&As, see Appendix C.

3.2.11.3.3 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.” 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.

In December 2016, the FASB issued ASU 2016-20, which amends the guidance in ASC 942-825-50-2 and ASC 310-10-60-4 to clarify that guarantee fees within the scope of ASC 460 or ASC 815 (other than product or service warranties) are not within the scope of ASC 606. For further discussion of the amendments in ASU 2016-20, refer to Section 20.3.3.6.

See TRG Agenda Paper 52 for additional information.

3.2.11.3.4 Arrangements Involving Bank-Issued Credit Cards

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.

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.”

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 legacy U.S. GAAP, credit card arrangements are typically accounted for under ASC 310.

19 Quoted from paragraph 61 of TRG Agenda Paper 52.
This issue is addressed in Implementation Q&As 1 and 2 (compiled from previously issued TRG Agenda Papers 36 and 44), which summarize the following observations and conclusions of the FASB staff:

- The FASB staff notes that all credit card fees have historically been accounted for under ASC 310 because they are related to credit lending activities (i.e., akin to loan origination fees). The staff also notes that the new revenue standard does not include consequential amendments to ASC 310. Accordingly, the staff believes that entities should continue to account for services exchanged for credit card fees under ASC 310 rather than ASC 606. However, the staff notes 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 indicates 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.

Note that outcomes under U.S. GAAP may differ from those under IFRS Standards because of differences between ASC 310 and IFRS 9.

3.2.11.4 Physically Settled Commodity Contracts That Are Derivatives

Entities that enter into contracts to deliver commodities (e.g., oil and gas, power and utilities, mining and metals, agriculture) may enter into firm contracts to deliver nonfinancial assets that are actively traded on the open market (e.g., electricity, grains) on a forward basis in exchange for a fixed amount of consideration. Even if an entity expects to physically settle a contract of this nature (i.e., by delivering the agreed-upon amount of the specified nonfinancial asset(s) on the forward date), if the contract could be net settled, the contractual rights and obligations might be within the scope of ASC 815.

If the rights and obligations associated with the contract are within the scope of ASC 815, then the contract is outside the scope of ASC 606 even if the derivative settles and the commodity is physically delivered to the customer in exchange for cash consideration. This is the case regardless of whether the entity's ordinary activities may include selling and physically delivering the commodity to third parties that would otherwise meet the definition of a customer. Further, because the contract is within the scope of ASC 815, the consideration received upon physical settlement of the derivative contract is also within the scope of ASC 815 (rather than ASC 606).

“Customer” is defined in ASC 606-10-20 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.” If an entity's ordinary activities include selling and physically delivering commodities to independent third parties in exchange for cash consideration, one might conclude that the counterparty in such a contract is a customer and that the contract is therefore within the scope of ASC 606. However, ASC 606-10-15-2 states, in part:

> An entity shall apply the guidance in this Topic to all contracts with customers, except the following: . . .

> c. Financial instruments and other contractual rights or obligations within the scope of the following Topics: . . .

> 7. Topic 815, Derivatives and Hedging [Emphasis added]

The scope assessment for contractual rights and obligations is performed at contract inception. That is, the contract is within the scope of ASC 815 both at contract inception and throughout the contract term. Therefore, even when the settlement of the contract — and physical delivery of the underlying commodity — are an output of the entity's ordinary activities, the contract is outside the scope of ASC 606 on the basis of the guidance in ASC 606-10-15-2(c)(7).
Further, ASC 815-10 provides a comprehensive framework for recognition, measurement, and presentation of derivatives, which covers settlement (including physical delivery). Consequently, the settlement of a contract should be presented in accordance with the guidance in ASC 815 and should not be included as a component of revenue from contracts with customers.

Example 3-9

Entity X, an agribusiness company whose ordinary activities include selling and physically delivering corn to independent third parties in exchange for cash consideration, enters into a contract to sell and physically deliver 5,000 bushels of corn on a forward basis for a fixed amount of cash consideration. In accordance with ASC 815-10-15-83, X has concluded the following:

- The contract has an underlying (i.e., the price of corn).
- The contract has a notional (i.e., 5,000 bushels of corn).
- Entity X makes no initial net investment in the contract.
- The underlying commodity to be physically delivered under the contract (i.e., corn) is readily convertible to cash (i.e., it meets the net settlement criteria).

On the basis of the characteristics of the contract described above, X has concluded that the rights and obligations associated with the contract should be accounted for as a derivative within the scope of ASC 815. Therefore, the contract is initially and subsequently measured at fair value, with changes in fair value recognized through net income. Since the scope assessment for contractual rights and obligations is performed at contract inception, the contract is within the scope of ASC 815 both at contract inception and throughout the contract term. Therefore, even when the settlement of the contract — and physical delivery of the corn — are an output of the entity's ordinary activities, the contract is outside the scope of ASC 606 on the basis of the guidance in ASC 606-10-15-2(c)(7).

3.2.11.5 Accounting for Proceeds From the Sale of Scrap Materials or By-Products

Generally, we would expect proceeds from an entity's sale of scrap materials or by-products that are produced as a result of the entity's manufacturing process to be treated as revenue within the scope of ASC 606. To determine whether to account for the proceeds as revenue under ASC 606, the entity must consider whether the proceeds represent revenue from a contract with a customer. Revenue is defined in the ASC 606 glossary as “[i]nflows . . . from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations” (emphasis added). The ASC 606 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” (emphasis added). Determining the entity's “ongoing major or central operations” and “ordinary activities” requires careful consideration of its specific facts and circumstances.

If it is determined that the proceeds from the sale are income from activities outside the entity's ongoing major or central operations and are therefore outside the scope of ASC 606, the proceeds may be within the scope of ASC 610-20 (see Chapter 18) and recognized outside operations as other income.
Chapter 4 — Step 1: Identify the Contract

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4.1 Overview

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 4.6), and revenue can only be recognized once (1) the contract existence criteria are met (under the assumption 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 legacy 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 4.3.

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 4.7) as well as the accounting for contract modifications (see Chapter 9).

4.2 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.

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 an 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.

### 4.3 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.

**Changing Lanes — Comparison of Requirements Under ASC 606 and ASC 605 for a Contract’s Existence**

The principles in ASC 606-10-25-1 for determining the existence of a contract are consistent with certain principles under legacy revenue guidance, 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. However, the criteria for establishing a contract under the new revenue standard are slightly different from the requirement to demonstrate persuasive evidence of an arrangement and that collectibility is reasonably assured under legacy U.S. GAAP. Nevertheless, the analysis under the new revenue standard will often be the same as that under legacy guidance, and changes in practice are expected to be infrequent and limited to certain industries (e.g., health care or software) or transactions. 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.

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1 ASC 985-605 (formerly SOP 97-2) uses the term “probable” as defined in ASC 450.
The examples below illustrate some of the circumstances in which the analysis may be different under the new revenue standard.

**Example 4-1**

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

In its response to Question 1 of SAB Topic 13.A.2, the SEC staff 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 presented by Question 1, revenue could not be recognized because the requisite approval from the customer's legal department was not obtained despite oral agreement by the customer's 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 4-2**

**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 4-1 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 4-3**

**ASC 954-605 — Collectibility**

In the health care industry, entities do not necessarily have to assess collectibility under legacy 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.

Sections 4.3.1 through 4.3.5.5 below further discuss each of the five criteria required to establish a contract with a customer.

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2 Question 1 of SAB Topic 13.A.2 opens as follows:

**Facts:** Company A has product available to ship to customers prior to the end of its current fiscal quarter. Customer Beta places an order for the product, and Company A delivers the product prior to the end of its current fiscal quarter. Company A’s normal and customary business practice for this class of customer is to enter into a written sales agreement that requires the signatures of the authorized representatives of the Company and its customer to be binding. Company A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the quarter. However, Customer Beta does not sign the agreement because Customer Beta is awaiting the requisite approval by its legal department. Customer Beta’s purchasing department has orally agreed to the sale and stated that it is highly likely that the contract will be approved the first week of Company A’s next fiscal quarter.

**Question:** May Company A recognize the revenue in the current fiscal quarter for the sale of the product to Customer Beta when (1) the product is delivered by the end of its current fiscal quarter and (2) the final written sales agreement is executed by Customer Beta’s authorized representative within a few days after the end of the current fiscal quarter?
4.3.1 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.”

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. Accordingly, entities will need to carefully consider termination clauses when evaluating whether each party is committed to the contract. For further discussion, see Sections 4.4 and 4.8.

Sometimes, after a contract between two parties expires and before they execute a new contract, both parties will continue to perform under the terms of the expired contract, thereby indicating that even in the absence of a formally executed contract, a contract may exist since both parties remain committed to perform. Entities should use caution in making this assessment and ensure that a careful evaluation of the specific facts and circumstances is performed to determine whether an enforceable contract exists.

**Example 4-4**

On May 1, 20X7, Entity A entered into a 6-month contract with Customer B to provide services in exchange for $100 per month. The contract did not include any automatic extension provisions and expired on October 31, 20X7. After the contract expired, the parties commenced negotiations for a new contract, under which A would provide the same services to B. The price that A would charge B for the services was the main point of negotiations between the parties. The two parties completed negotiations and executed a new, 12-month contract on January 31, 20X8, that is retroactive to November 1, 20X7. The new contract requires B to pay $150 per month.

Entity A’s customary business practice is to continue providing services to a customer while negotiations for a new contract occur after the expiration of an existing contract. Accordingly, during the interim period (i.e., November 1, 20X7, through January 31, 20X8) in which contract negotiations occurred, A continued to provide services and B continued to pay $100 per month. The $100 monthly fee paid by B during the interim period is nonrefundable.

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3 Quoted from paragraph BC36 of ASU 2014-09.
Example 4-4 (continued)

Aside from the increased fee and longer contract duration, all other contract attributes are the same between the expired contract and the new contract, and no disputes occurred during the interim period.

To determine whether a contract existed during the interim period while a new contract was being negotiated, A should evaluate whether each party had enforceable rights and obligations during the interim period. ASC 606-10-25-2 states, in part, that “[e]nforceability of the rights and obligations in a contract is a matter of law.” This assessment requires judgment, especially in the absence of automatic renewal provisions in the original contract. Accordingly, A should analyze the parties’ rights and obligations to determine the legal enforceability of the contract in the relevant jurisdiction.

Entity A should also consider whether the negotiations and execution of the new contract are within the scope of the new revenue standard’s guidance on contract modifications. ASC 606-10-25-11 notes that a contract modification may exist when a change in the scope or price of the contract has not yet been resolved. When a change in scope has been approved by the parties, an entity is required under ASC 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.

In the situation described above, it appears that a contract existed during the interim period because A continued to provide services to B in a manner consistent with A’s customary business practice. Further, in exchange for the services and in accordance with the terms of the original contract, B continued to pay A $100 per month, which is nonrefundable. On the basis of these facts, it appears that both parties had enforceable rights and obligations during the interim period and that it would therefore be inappropriate to delay revenue recognition until the new agreement was signed on January 31, 20X8. Upon execution of the new agreement, A should analyze the new revenue standard’s guidance on contract modifications to determine the appropriate accounting.

Certain arrangements provide a customer with free goods or services at the onset of the arrangement. In these circumstances, entities must carefully evaluate whether all of the criteria in ASC 606-10-25-1 are met. If the goods or services are provided as part of a “free trial period,” each party may not have approved the contract or be committed to perform during that period.

Example 4-5

Entity A has a marketing program that offers a three-month “trial period” during which a customer can obtain free issues of a monthly magazine. If the customer does not cancel at the end of three months, it will be charged the annual subscription fee of $144, or $12 per month (inclusive of the trial period).

Because the customer in the arrangement is not committed to perform, no contract exists during the free trial period unless and until the customer “accepts” the offer. Once the customer accepts the offer and has the intent and ability to pay $144 for an annual subscription to the monthly magazine (i.e., collectibility is probable), a valid contract exists and the rest of the revenue recognition model can be applied.

Questions have been raised about whether any of the transaction price should be allocated to the free goods or services once the existence of a contract is established. For further discussion, see Section 8.9.3.

4.3.2 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).
4.3.3 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 6.3 for information about variable consideration.

4.3.4 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).

Connecting the Dots — 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 an entity sells goods or services to a customer that in turn sells the same or similar goods or services back to the entity. 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.⁴

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 Section 8.9.2 for a discussion of how to account for these types of arrangements once the contract existence criteria are met. In addition, see Section 13.3 for further discussion of capitalization of certain costs that an entity incurred to fulfill a specific anticipated contract with a customer.

4.3.5 Collectibility Is Probable
ASC 606-10-25-1(e) requires an entity to evaluate whether it is probable⁵ 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 4.5). 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

⁴ ASC 845 addresses purchases and sales of inventory with the same counterparty and the circumstances in which nonmonetary exchanges of inventory in the same line of business are recognized at the carrying amount of the inventory transferred.
⁵ As noted in Appendix A, the collectibility threshold under U.S. GAAP differs from that under IFRS Standards.
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.

### 4.3.5.1 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 concessions are a form of variable consideration (see Section 6.3) 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 on the basis of all relevant facts and circumstances in determining whether they have provided an implicit price concession (variable consideration to be estimated in step 3, as discussed in Chapter 6) or have accepted a customer’s credit risk (to be evaluated in step 1 herein). 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.

The following indicators may suggest that rather than accepting the customer’s credit risk, the entity has offered a price concession (which would be evaluated as variable consideration):

- 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).
Chapter 4 — Step 1: Identify the Contract

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.
**ASC 606-10 (continued)**

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.

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.

### 4.3.5.2 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 legacy practice, entities will continue to (1) assume collection risk and (2) incur bad debt.

The following indicators may suggest that rather than granting a price concession, the entity has incurred a bad debt:

- The entity has the ability and intent 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 significantly 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 legacy 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 legacy 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 legacy 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 have historically recognized revenue in a manner similar to the cash basis of accounting when collectibility is not reasonable assured. See Section 4.6 for further discussion of accounting for consideration received when the criteria for identifying a contract are not met.

4.3.5.3 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.

In ASU 2016-12, the FASB (1) further clarified the objective of the collectibility threshold, (2) provided implementation guidance on how to evaluate circumstances in which credit risk is mitigated, and (3) added guidance on when revenue should be recognized if a contract fails to meet the requirements in ASC 606-10-25-1 (see Section 4.6).

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

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6 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 U.S. GAAP and IFRS Standards on revenue-related topics.
ASC 606-10 (continued)

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.

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:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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<tbody>
<tr>
<td><strong>Example 1 — Collectibility of the Consideration</strong></td>
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<tr>
<td><strong>Case A — Collectibility Is Not Probable</strong></td>
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<tr>
<td><strong>55-95</strong> 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.</td>
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<td><strong>55-96</strong> 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.</td>
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<td><strong>55-97</strong> 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:</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>b. The customer lacks other income or assets that could be used to repay the loan.</td>
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<tr>
<td>c. The customer's liability under the loan is limited because the loan is nonrecourse.</td>
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<tr>
<td><strong>55-98</strong> 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.</td>
</tr>
<tr>
<td><strong>Case B — Credit Risk Is Mitigated</strong></td>
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<tr>
<td><strong>55-98A</strong> 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.</td>
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<td><strong>55-98B</strong> 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.</td>
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<tr>
<td><strong>55-98C</strong> 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.</td>
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<tr>
<td><strong>55-98D</strong> 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.</td>
</tr>
</tbody>
</table>
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

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.

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.

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.

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

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.
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.

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).

**Connecting the Dots — 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 significantly 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.

**4.3.5.4 Whether to Assess Collectibility at the Portfolio Level or the Individual Contract Level**

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. However, if an entity has a portfolio of contracts that are all similar, particularly in terms of collectibility, and historical evidence suggests that a proportion of the consideration due from contracts in the portfolio will not be collected, the entity may evaluate that portfolio to assess whether an individual contract is collectible.
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. That is, an entity should not ignore information that suggests that there is a specific (i.e., identified) contract within a portfolio for which collectibility is not considered probable. If that is considered to be the case, the specific contract should be excluded from the portfolio and evaluated on an individual basis; if the contract does not meet the collectibility criterion, it 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.

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 (or ASC 326, once adopted\(^7\)).

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

The above issue is addressed in Q&A 9 (compiled from previously issued TRG Agenda Papers 13 and 25) of the FASB staff’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

### 4.3.5.5 Assessing Collectibility in Real Estate Sales

Under the legacy guidance in ASC 360-20 on the sale of real estate with seller financing, the seller in such a transaction 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 4.2, the contract existence criteria need to be met before a sale can be recorded in accordance with ASC 606 or ASC 610-20 (see Chapter 18). 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.

\(^7\) See ASC 326-10-65-1 through 65-4 for effective date and transition guidance related to ASC 326.
Chapter 4 — Step 1: Identify the Contract

ASC 606 contains an example of a real estate sale (see Section 4.3.5.3) 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), the contract existence criteria are deemed not to have been met. Further, control of the building is not transferred 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.

4.4 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 Chapter 11.

<table>
<thead>
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<th>ASC 606-10</th>
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<tbody>
<tr>
<td>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.</td>
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4.4.1 Termination Clauses and Penalties

When contracts have termination clauses and penalties, 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 any termination penalty is 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.

A contract's accounting term could be less than the contract's stated term if a termination penalty is not substantive. For example, a 12-month stated contract term could, in effect, be a month-to-month contract if the contract could be terminated each month and the termination penalty is not substantive. An entity will need to carefully consider the effect of nonsubstantive termination penalties on the timing and amount of revenue to be recognized.
Because the assessment of termination clauses and penalties focuses on legally enforceable rights and obligations, certain economic factors such as economic compulsion should not be considered. Rather, the assessment depends on whether the terminating party is required to compensate the other party. For example, an entity may have a long-term agreement with a customer for a unique good or service that is critical to the customer’s operations. If the agreement allows the customer to terminate it at any point and there are no contractual penalties if the customer does not purchase any goods or services, a contract for the purchase of additional goods or services does not exist even if it is highly likely that the customer will not terminate the agreement.

The determination of whether a termination penalty is substantive requires judgment and would be evaluated both quantitatively and qualitatively. For example, 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 penalty is not substantive). 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. When a customer has a right to terminate the contract without penalty, such termination provision is substantively the same as a renewal provision, as supported by paragraph BC391 of ASU 2014-09 (as well as by Implementation Q&A 8). Example 4-6 below illustrates how an entity should consider a fixed-term contract that allows a customer to terminate the contract without penalty after a certain period.

**Example 4-6**

Company A has a contract to deliver various goods and services to Customer B. The contract includes pricing for the goods or services for a two-year period but allows B to cancel the contract at any time after six months without paying a penalty. In this scenario, we generally believe that the enforceable rights and obligations of the contract are for six months; therefore, the contract term is six months. Since the pricing terms of the arrangement are fixed for two years, A would also need to evaluate whether a material right exists for purchases beyond six months.

**Connecting the Dots — Evaluating the Contract Term When the Customer May Forgo a Discount**

As discussed above, 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 certain economic factors into account (e.g., economic compulsion). Accordingly, the economic considerations related to forgoing a discount on optional purchases would not be viewed as a substantive penalty suggesting that the parties’ rights and obligations extend for a longer contract term. The discount on optional purchases should be assessed for the existence of a material right instead. This approach is consistent with the discussion in Implementation Q&A 8, which states that “an entity would still evaluate whether the termination right (which is akin to an option for additional goods or services) gives rise to a material right.” Therefore, while an “economic” penalty may be incurred by a customer that elects not to purchase future but optional goods at a discount, that economic penalty would not rise to the level of a substantive penalty that lengthens the contract term.

The above issue is addressed in Implementation Q&As 7 and 8 (compiled from previously issued TRG Agenda Papers 10, 11, 48, and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.
4.4.1.1 Termination Clauses in License Arrangements

As noted in Section 4.4.1, an entity needs to evaluate the nature of termination provisions, including whether any penalties are substantive (i.e., whether the transfer of any consideration from the customer to the entity is substantive). Careful consideration is required in the evaluation of whether giving up license rights is a form of penalty. Examples 4-7 and 4-8 below illustrate how an entity would determine whether a license arrangement includes a substantive termination penalty.

**Example 4-7**

**License Arrangement Includes a Substantive Termination Penalty**

Company A, a pharmaceutical company in the United States, owns and maintains a portfolio of patents related to an antibiotic that treats life-threatening diseases. On February 23, 20X8, A grants Customer B (a pharmaceutical company in Ireland) the exclusive right to use its patented drug formula to commercialize and supply the antibiotic in Europe. The IP is fully developed, and regulatory approval has been obtained; therefore, B is able to commercialize the IP. Company A has determined that the patented drug formula is functional IP and that therefore, the license grants B the right to use the IP. In exchange for the exclusive right to use the patented drug formula, B agrees to pay A the following amounts:

- An up-front fee of $300 million.
- Annual fixed fees of $50 million payable at the end of each year in which the contract is effective.
- Sales-based royalties of 5 percent of B's sales of the antibiotic in Europe (recognized in accordance with the sales-based royalty exception in ASC 606-10-55-65).

The contract states that B has the exclusive right to use the patented drug formula through the patent term, which expires in 10 years (i.e., the contract ends when the patent expires). Notwithstanding the stated contract term, the contract states that B may terminate the contract before the expiration of the patent by providing three months' notice to A. All amounts already paid by B are nonrefundable in the event of early termination. The contract does not include an explicit termination penalty (i.e., B is not required to pay additional cash consideration to A upon early termination); however, upon early termination, the right to the patented drug formula in Europe would revert back to A, and A would be able to relicense the patented drug formula to a different pharmaceutical company in Europe. Unless B terminates the contract before the end of the stated term, A would not be able to benefit from licensing the patented drug formula to a different pharmaceutical company in Europe (i.e., A would receive this benefit only upon B's early termination of the contract).

Under these facts, A’s contract to license the exclusive right to use its patented drug formula to B contains a substantive termination penalty. As previously discussed in Section 4.4.1, it is important for an entity to evaluate the nature of the termination provisions in its contracts to determine the appropriate contract term for applying ASC 606. Implementation Q&As 7 and 8 include the following factors that an entity should consider when determining whether a termination penalty is substantive:

- Whether the terminating party is required to pay compensation.
- The amount of such compensation.
- The reason for the compensation (i.e., whether the compensation is in addition to amounts due for goods and services already delivered).
Example 4-7 (continued)

In this example, A’s contract to license the patented drug formula to B does not include an explicit termination penalty. That is, B can terminate the contract before the end of the stated term by providing three months’ notice without paying additional cash consideration to A. Although the contract does not require B to pay additional cash consideration to A upon early termination, in the event that B terminates the contract early, the exclusive license rights related to the patented drug formula would revert back to A. Company A would then be able to license the patented drug formula to another customer in Europe for the remainder of the patent term, which it would not have been able to do if B had not terminated the contract. Therefore, although B is not paying additional cash to A upon termination, B is providing consideration (i.e., something of value) to A, and A is receiving something of value from B (i.e., the right to relicense the patented drug formula), upon termination. Although Implementation Q&As 7 and 8 focus on compensation as additional cash that an entity’s customer would pay to the entity upon termination, compensation may also include noncash consideration that is of value to the entity. The fact that B is forfeiting its rights to the patented drug formula and providing A with something of value (i.e., the ability to relicense the patented drug formula to another customer in Europe) from the forfeiture upon early termination represents a substantive termination penalty in the contract.

In accordance with Implementation Q&As 7 and 8, the substantive termination penalty suggests that the parties’ rights and obligations extend for the duration of the stated contract term. That is, the contract term is 10 years.

Example 4-8

License Arrangement Does Not Include a Substantive Termination Penalty

Company X, a multinational software company, is a provider of financial software that can be used to track a user’s investments. On June 29, 20X8, X grants Customer Y a nonexclusive license to use X’s financial software to track Y’s personal investments for five years. The contract also includes PCS for the five-year term. Company X also grants other customers a similar license to use its financial software (i.e., the license is not exclusive). In exchange for the right to use X’s financial software, Y agrees to pay X the following amounts:

- An up-front fee of $500.
- An annual fee of $50, payable at the beginning of each year.

The contract states that Y may terminate the contract before the expiration of the five-year stated term by providing three months’ notice to X. All amounts already paid by Y are nonrefundable in the event of early termination. The contract does not include an explicit termination penalty (i.e., Y is not required to pay additional cash consideration to X upon early termination). Upon early termination, Y must forfeit its right to use X’s financial software (and, accordingly, terminate the PCS arrangement).

Under these facts, X’s contract to license its financial software to Y does not contain a substantive termination penalty. Like the contract in Example 4-7, X’s contract with Y does not contain an explicit termination penalty (i.e., Y is not required to pay additional cash consideration to X upon early termination). However, as illustrated in Example 4-7, it is important to consider whether the licensor is receiving other forms of compensation (i.e., noncash consideration that represents value to the licensor from the licensee upon termination) to determine whether the contract includes a substantive termination penalty. Unlike the license in Example 4-7, X’s license to use its financial software is not exclusive to one customer. In addition to licensing the software to Y, X licenses the software to other customers at the same time. Although Y must forfeit its right to use X’s financial software upon termination of the contract, Y is not providing anything of value to X, and X is not receiving anything of value from Y, upon early termination. Therefore, the contract does not contain a substantive termination penalty. In a manner consistent with the discussion in Section 4.4.1, this would suggest that X and Y have enforceable rights and obligations for only the first three months of the contract because three months is the amount of time that Y would need to provide as notice to X to terminate the contract.
4.5 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 (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). 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.

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, such as ASC 310 (or ASC 326, once adopted).

ASC 606-10

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<th>Paragraph</th>
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<td><strong>25-5</strong></td>
<td>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).</td>
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<tr>
<td><strong>25-6</strong></td>
<td>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.</td>
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</table>

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. 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.” 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, which is reproduced below, 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 in the example 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.

See footnote 7.
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.

Pending Content (Transition Guidance: ASC 326-10-65-1)

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 credit losses on the existing receivable in accordance with Subtopic 326-20 on financial instruments measured at amortized cost.

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.

Pending Content (Transition Guidance: ASC 326-10-65-1)

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 additional credit losses on the existing receivable in accordance with Subtopic 326-20.
Connecting the Dots — 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 assessment of whether a significant change in facts and circumstances occurred will be situation-specific (e.g., a significant change due to a bankruptcy) and will often be a matter of judgment.

The above issue is addressed in Implementation Q&A 10 (compiled from previously issued TRG Agenda Papers 13 and 25). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

4.6 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.

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.

Connecting the Dots — 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.

4.6.1 Whether a Contract Can Be Deemed Terminated if Pursuit of Collection Continues

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),9 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.

4.6.2 Whether a Receivable Can Be Recorded When a Contract Fails Step 1 Because Collectibility Is Not Probable

If an entity 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.

ASC 606-10-45-4 states, in part, the following (pending content effective later than the effective date of ASC 606 {in braces}):

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 Topic 310 {and Subtopic 326-20}.

In general, an entity cannot 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. 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.

9 The IASB did not amend IFRS 15 to add this third criterion. For a summary of differences between U.S. GAAP and IFRS Standards on revenue-related topics, see Appendix A.
Example 1, Case A, in 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 included the following text (subsequently deleted from ASC 606-10-55-98 by ASU 2016-12), which we still believe appropriately reflects the timing of recognizing receivables for 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]

ASU 2016-12 deleted the text above from ASC 606-10-55-98 to make the Codification example 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.

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.

### 4.7 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 legacy 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.

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10 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.
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.

Changing Lanes — Consistency With Legacy Guidance

The requirement for combining contracts is similar to legacy 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.

4.8 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 4.3.1, the new revenue standard does not apply to wholly unperformed contracts that allow either party the unilateral ability to terminate a contract. See Section 4.4.1 for further discussion of termination provisions. If an entity enters into a contract with a customer and only the entity can cancel the contract (i.e., the customer does not have an ability to terminate the contract), the contract exists for accounting purposes under ASC 606 because the entity has an enforceable right to consideration if it chooses to perform (e.g., transfer goods or services to the customer).

4.9 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
5.2 Promises in Contracts With Customers
5.3 Identifying Performance Obligations in a Contract
5.4 Defining the Nature of the Promise
5.5 Warranties
5.6 Nonrefundable Up-Front Fees
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 on the next page illustrates the new revenue standard’s process for identifying performance obligations in a contract.
Chapter 5 — Step 2: Identify the Performance Obligations

Identify all explicitly and implicitly promised goods and services in the contract.

Are all promised goods and services material in the context of the contract?

- Yes
  - Continue with the analysis for each material promised good or service as follows.

- No
  - Exclude immaterial promises from further analysis.

Material Promises

Distinct Criteria

Is the good or service (or bundle of goods and services) capable of being distinct?

- Yes
  - Is the good or service (or bundle of goods and services) distinct within the context of the contract?

- No
  - Combine two or more promised goods or services and reevaluate the new bundle.

Is the good or service (or bundle of goods and services) capable of being distinct?

- Yes
  - Is the good or service (or bundle of goods and services) distinct within the context of the contract?

- No
  - Continue with the analysis for each material promised good or service as follows.

Distinct Criteria

Series Criteria

Is the distinct good or service (or bundle of goods and services) part of a series of distinct goods or services that are substantially the same?

- Yes
  - Is each transfer of a distinct good or service satisfied over time, and does each transfer of a distinct good or service satisfied over time have the same measure of progress? Refer to Chapter 8.

- No
  - Account for the distinct good or service as a performance obligation.

- Yes
  - Account for the series of distinct goods or services as a single performance obligation.

Series Criteria
This chapter also addresses topics such as stand-ready obligations, options for additional goods and services, warranties, and nonrefundable up-front fees because these topics are integral to the proper identification of 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.

In addition, an entity’s contract with a customer may give the customer a choice of whether to purchase additional goods or services. In some cases, options for additional goods or services are marketing or promotional efforts to gain future contracts with customers. However, in other cases, such options may be considered performance obligations, which are referred to as material rights. While the determination of whether a customer option for additional goods or services gives rise to a material right should be performed as part of step 2, there are many considerations related to material rights that affect the other steps of the revenue recognition model. Accordingly, material right considerations are discussed separately in Chapter 11.

### 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:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
<th>25-18</th>
<th>Depending on the contract, promised goods or services may include, but are not limited to, the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>a.</td>
<td>Sale of goods produced by an entity (for example, inventory of a manufacturer)</td>
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<td></td>
<td>b.</td>
<td>Resale of goods purchased by an entity (for example, merchandise of a retailer)</td>
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<tr>
<td></td>
<td>c.</td>
<td>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)</td>
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<tr>
<td></td>
<td>d.</td>
<td>Performing a contractually agreed-upon task (or tasks) for a customer</td>
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<tr>
<td></td>
<td>e.</td>
<td>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</td>
</tr>
<tr>
<td></td>
<td>f.</td>
<td>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)</td>
</tr>
<tr>
<td></td>
<td>g.</td>
<td>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)</td>
</tr>
<tr>
<td></td>
<td>h.</td>
<td>Constructing, manufacturing, or developing an asset on behalf of a customer</td>
</tr>
<tr>
<td></td>
<td>i.</td>
<td>Granting licenses (see paragraphs 606-10-55-54 through 55-60 and paragraphs 606-10-55-62 through 55-65B)</td>
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<td></td>
<td>j.</td>
<td>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).</td>
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</tbody>
</table>
5.2.2  Implied Promises

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).” Therefore, promises that an entity’s customer reasonably expects the entity to fulfill even though they are not explicitly stated in the contract are implied promises that should be accounted for.

Connecting the Dots — Implied Promises

While software companies applying ASC 985-605 may be familiar with identifying implied promises through software upgrades and updates, other types of entities may be less accustomed to this analysis. For example, a manufacturer of furniture may provide a written warranty to its customers to repair the products in the first year after purchase. However, if the manufacturer also has historically provided repairs free of charge beyond the first year in accordance with the manufacturer’s customary business practice, an implied promise may exist.

The concept of implied promises 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 a reasonable 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 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.

1 In April 2016, the FASB issued ASU 2016-10. As a result of ASU 2016-10, the customer’s “valid” expectation, as discussed in paragraph BC87 of ASU 2014-09, was changed to the customer’s “reasonable” expectation under ASC 606-10-25-16.
5.2.2.1 Illustrative Examples in ASC 606 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.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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</thead>
<tbody>
<tr>
<td><strong>Example 12 — Explicit and Implicit Promises in a Contract</strong></td>
</tr>
</tbody>
</table>

**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.

**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.

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.

5.2.2.2 Accounting for Virtual Goods

Many developers of online games allow customers to access and play the games for no charge. Rather than licensing the software to their customers, the developers generally host the software for their customers to access. Historically, arrangements that allow customers of online game developers to access and play online games have been accounted for outside of ASC 985-605 because the customers cannot take possession of the software associated with the online games. That is, this type of arrangement has been and is expected to continue to be accounted for as a service (hosted software as a service) rather than the transfer of a software license.

To enhance the gaming experience of customers who can access and play online games for no charge, online game developers may give them the option to purchase virtual goods or services (i.e., virtual items). These virtual items are generally classified as either (1) consumables (i.e., items that are consumed by a specific action and are no longer available to a customer once consumed, such as virtual groceries) or (2) durables (i.e., items that are accessible to a customer for use throughout the entire game, such as a virtual house). In addition, customers may have the ability to purchase virtual currency, which enables them to purchase other virtual items.

In effect, customers are enhancing their gaming experience through optional purchases. Some of these purchases are “consumed” by a player immediately or shortly after they gain access to them, and others are consumed over time. Nevertheless, even when an item is consumed immediately, it may still have an ongoing effect on the player’s gaming experience (e.g., if consumption of the item enables the player to reach another level that would otherwise have been inaccessible).

Generally, a developer is not contractually obligated to continue making an online game available to a customer. Further, a developer can terminate a customer’s account at any time for no cause, regardless of whether the customer has purchased virtual items. Nevertheless, many developers have a customary business practice of notifying customers when they are planning to shut down an online game, although such notification is not contractually required.
Generally, an implied promise would exist since the developer has implicitly promised to provide hosting services after the customer purchases a virtual item. Without the hosting services, the customer would not be able to use and benefit from the enhanced gaming experience that it receives through the game as a result of purchasing the virtual item. Although the developer is not contractually obligated (i.e., it has not explicitly promised) to continue hosting the online game for the customer, it has established a customary business practice of (1) continuing to host the online game and (2) notifying customers when it is planning to shut down the game. The developer’s customary business practice creates a reasonable expectation that the developer will continue to host the software so that the virtual item (or the enhanced gaming experience derived from the virtual item) will remain available to the customer.

A developer should carefully consider the nature of the implied promise to its customer in determining the appropriate recognition model. Customers often simultaneously receive and consume the benefits of the developer’s performance of making the hosted software available to the customer. Consequently, the developer may determine that it should recognize revenue for its implied promise over time by using a method that faithfully depicts its performance in transferring control of the promised services (i.e., the benefits of the enhanced gaming experience related to the purchase of virtual items promised to the customer). Immediate recognition of revenue at the point in time when a customer purchases a virtual item may not be appropriate if the benefits of the enhanced gaming experience are provided over time. Rather, the entity may need to consider the period over which the customer benefits from the enhanced gaming experience that it receives by purchasing the virtual item when determining the appropriate period and pattern of revenue recognition.

We believe that the following may be relevant factors for an entity to consider in making this assessment:

- Whether the nature of the implied promise is to provide an enhanced gaming experience through the hosted service over time or to enable the player to consume virtual items.
- The period over which the enhanced gaming experience is provided if the benefits are consumed throughout the hosting period (e.g., user life, gaming life).
- The life span over which, or number of times, the virtual item may be accessed or used.
- Whether the virtual item must be used immediately or may be stored for later use.
- How and over what period the virtual item benefits the customer’s gaming experience (e.g., a consumable such as a virtual meal that is used immediately vs. a durable that allows a player to “level up” within the game in such a way that the increased performance continues to enhance the gaming experience).
- Whether the benefit of purchasing the virtual item on the customer’s gaming experience is temporary or permanent.

For additional information about the timing of revenue recognition, see Chapter 8.
5.2.3 Immaterial Promises

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-16A</strong> 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.</td>
</tr>
<tr>
<td><strong>25-16B</strong> 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.</td>
</tr>
</tbody>
</table>

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, paragraph BC90 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.

In April 2016, the FASB issued ASU 2016-10, 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 Chapter 11.

ASU 2016-10 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.

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2 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 U.S. GAAP and IFRS Standards on revenue-related topics, see Appendix A.
5.2.3.1 Accounting for Perfunctory or Inconsequential Performance Obligations

The determination of whether a promise in a contract is perfunctory or inconsequential is not expected to change significantly under ASC 606 from what it would have been under legacy guidance. Under legacy guidance, SAB Topic 13.A indicates that a deliverable is inconsequential if an entity's failure to complete the actions specified in a contract would not result in (1) a full or partial refund to the entity's customer or (2) a rejection of the finished product or service by the customer. SAB Topic 13.A includes additional factors to consider as indicators that a deliverable is substantial rather than inconsequential or perfunctory. Under ASC 606, perfunctory or inconsequential promises in a contract may be, but are not presumed to be, immaterial in the context of the contract.

Example 5-1

Entity X enters into a contract 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).

Even if Item B is considered perfunctory or inconsequential, X cannot ignore the guidance in ASC 606 when determining whether and, if so, how to account for it. 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, X may need to reevaluate historical conclusions by using the new framework outlined in ASC 606-10-25-16A and 25-16B.

5.2.3.2 Framework for Identifying Immaterial Promised Goods or Services

ASC 606-10-25-16A and 25-16B (reproduced in Section 5.2.3) provide guidance on immaterial goods and services. 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. We believe that the following considerations 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 ASC 606-10-25-16B 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. For additional information about the accounting for material rights, see Chapter 11.
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.

5.2.4.1 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.³

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 (e.g., if they meet the criteria in ASC 340-40-25-5) or expensed as incurred.

When performing an assessment of whether preproduction activities transfer a good or service to a customer, 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.

³ Such a preproduction activity could be a performance obligation in its own right or could form part of a larger performance obligation.
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 is, or 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.

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 is, or forms part of, a performance obligation.

**Example 5-2**

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 are, or form part of, the performance obligation(s) in the contract with the customer.

The above issue is addressed in Q&A 16 (compiled from previously issued TRG Agenda Papers 46 and 49) of the FASB staff's Revenue Recognition Implementation Q&As (the “Implementation Q&As”). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

**5.2.4.2 Promise to Stand Ready to Accept a Returned Product**

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. ASC 606-10-55-24 states that 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” (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.

For further discussion of sales with a right of return, see Section 6.3.5.3. For stand-ready obligations to provide goods or services, see Section 5.4.3.
5.2.4.3 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 legacy 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.

In April 2016, the FASB issued ASU 2016-10, which provides a practical expedient that 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).

**Connecting the Dots — 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.

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4 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 U.S. GAAP and IFRS Standards on revenue-related topics.
In a speech at the 2017 AICPA Conference on Current SEC and PCAOB Developments, Barry Kanczuker, associate chief accountant in the SEC’s Office of the Chief Accountant (OCA), provided the following guidance on the classification of shipping and handling expenses:

The staff has received questions under Topic 606 regarding the classification of shipping and handling expenses. Under Topic 606, if the shipping and handling activities are performed before the customer obtains control of the good, a registrant would account for the shipping and handling as activities to fulfill the promise to transfer the good. If shipping and handling is performed after a customer obtains control of the good, an entity may either account for shipping and handling as a promised service to the customer or elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The questions we received related specifically to those shipping and handling expenses that were accounted for as activities to fulfill the promise to transfer the good, and these questions arose because the prior guidance on classification of shipping and handling expenses, and the explicit policy election regarding classification of such costs, was superseded by the new revenue standard, which now does not include any guidance that addresses the classification of shipping and handling expenses.

Given the noted absence of any guidance, I believe an entity will need to apply reasonable judgment in determining the appropriate classification of shipping and handling expenses for those shipping and handling activities that are accounted for as activities to fulfill the promise to transfer the good. Hence, the staff noted it would not object to the following approaches. First, the staff noted that it would not object to classification of these expenses within cost of sales. Second, given that there is no explicit guidance within Topic 606 related to the classification of shipping and handling expenses, the staff noted that it also would not object to an entity continuing to apply its previous policy regarding classification of these expenses, which could potentially be outside of cost of sales. I believe that a registrant that classifies significant shipping and handling costs outside of cost of sales should consider whether it should disclose the amount of such costs and the line item or items on the income statement that include them, similar to the disclosures required under the previous guidance.

[Footnotes omitted]

### 5.2.4.4 Mobilization Activities

In some industries, entities may perform “mobilization” activities at or near contract inception to fulfill their performance obligations under contracts within the scope of ASC 606 (e.g., transportation of equipment to the construction site). Questions have arisen about how an entity should account for such mobilization activities. Frequently, these activities do not result in the transfer of a good or service to the customer; rather, they represent set-up activities and are therefore not accounted for as part of the performance obligation(s) in the contract with the customer. Refer to Section 13.3.5 for a discussion about the accounting for incurred costs related to set-up activities and mobilization.

### 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.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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| 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). |
Chapter 5 — Step 2: Identify the Performance Obligations

Changing Lanes — Deliverables and Units of Accounting

The concept of grouping deliverables into units of accounting under legacy 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 legacy 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.

Connecting the Dots — Determining Whether Unbundling Is Optional

The process of identifying performance obligations is sometimes referred to as “unbundling,” which is not optional. 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, however, it may not be necessary to apply the detailed guidance in ASC 606 on unbundling if the amounts recognized and disclosed in the financial statements will be the same irrespective of whether unbundling is performed. 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, and if those items do not need to be segregated for disclosure purposes, 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. The boards acknowledged this in paragraph BC116 of ASU 2014-09 as follows:

In their redeliberations, the Boards observed that paragraph 606-10-25-14(b) applies to goods or services that are delivered consecutively, rather than concurrently. The Boards noted that Topic 606 would not need to specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. This is because, in those cases, an entity is not precluded from accounting for the goods or services as if they were a single performance obligation, if the outcome is the same as accounting for the goods and services as individual performance obligations.
In addition, paragraph BC47 of ASU 2016-10 states:

In many contracts, distinct sets of rights are coterminous. That is, the rights are transferred to the customer at the same point in time (in the case of licenses that provide a right to use intellectual property) or over the same period of time (in the case of licenses that provide a right to access intellectual property). Consistent with the discussion in paragraph BC116 of Update 2014-09, an entity would not be required to separately identify each set of distinct rights if those rights are transferred concurrently. For example, a licensor would not be precluded from accounting for the two sets of distinct rights in Example 61B as a single performance obligation if the facts of that example were modified such that the customer was able to begin to use and benefit from both sets of rights on January 1, 20X1 (rather than Class 1 on January 1, 20X1, and Class 2 on January 1, 20X2).

The sections below discuss various types of performance obligations. However, for a discussion of material rights, see Chapter 11.

### 5.3.2 Criteria to Be Distinct

<table>
<thead>
<tr>
<th>ASC 606-10</th>
<th>25-19 A good or service that is promised to a customer is distinct if both of the following criteria are met:</th>
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<tbody>
<tr>
<td></td>
<td>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).</td>
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<tr>
<td></td>
<td>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).</td>
</tr>
<tr>
<td>25-22</td>
<td>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.</td>
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</tbody>
</table>

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. 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 or services in the contract until the criteria are met. For illustrations of how an entity should combine the promises in a contract until those promises meet the criteria to be a performance obligation, see Cases A, B, and C of Example 10 in ASC 606, which are reproduced in Section 5.3.2.3.

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5. See paragraph BC98 of ASU 2014-09.
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 12.3, 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 legacy 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

<table>
<thead>
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</table>
| 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. |

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 legacy 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 paragraph BC31 of ASU 2016-10 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.

5.3.2.2.1 Providing a Service to Integrate a Good or Service With Other Goods or Services

As discussed in paragraph BC107 of ASU 2014-09, when an entity evaluates whether a contract with a customer provides for a significant service of integrating a good or service with other goods or services, the entity should consider whether the risk of transferring that good or service is inseparable from the risk of transferring the other goods or services because the promise in the contract is to ensure that the individual goods or services are incorporated into the combined output for which the customer has contracted. 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.

This concept is further discussed in paragraph BC29 of ASU 2016-10, which states that the entity should consider “whether the multiple promised goods or services in the contract are outputs or, instead, are inputs to a combined item (or items).” The paragraph goes on to explain that the combined item “is greater than (or substantively different from) the sum of those promised (component) goods and services.” If multiple promised goods or services represent inputs rather than individual outputs, such goods or services would not be separately identifiable.

In a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments, OCA Professional Accounting Fellow Sheri York discussed her views on determining whether an entity provides a significant integration service that results in a combined performance obligation of equipment and services:

In a recent consultation with OCA, a registrant provided its customer with a commercial security monitoring service by integrating a variety of cameras and sensors . . . with the registrant’s technology platform. . . . The registrant believed it was providing a significant service of integrating the goods and services in the contract into a bundle that represented the combined output for which the customer had contracted. More specifically, the delivery of a “smart” security monitoring service would not be possible if the equipment were not integrated with the technology platform. . . . In this fact pattern, the entity demonstrated reasonable judgment that they were providing a significant integration service that transformed the equipment and services into a combined output that provided the customer with an overall service offering that was greater than the customer could receive from each individual part. [Footnotes omitted]
5.3.2.2.2 Significant Modification or Customization

In certain circumstances, an entity’s contract with a customer may contain a promise to modify or customize another promised good or service in the contract such that the customer’s expectation is the delivery of the modified or customized good or service. 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 could really benefit from the software without the customization.

5.3.2.2.3 Goods or Services Are Highly Interdependent or Interrelated

In certain cases, goods or services are so highly interdependent or interrelated that the utility of each individual good or service is significantly affected by other goods or services in the contract. 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 the 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.

Paragraphs BC32 and BC33 of ASU 2016-10 further expand on the concept of whether goods or services are highly interdependent or interrelated. Paragraph BC32 of ASU 2016-10 states, in part:

The separately identifiable principle is intended to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. That is, the separately identifiable principle is intended to evaluate when an entity’s performance in transferring a bundle of goods or services in a contract is, in substance, fulfilling a single promise to a customer. Therefore, the entity should evaluate whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. The entity should not merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract).

Paragraph BC33(b) of ASU 2016-10 discusses how the utility of a promised good or service may depend on the other promised goods or services in a contract and therefore each good or service may significantly affect the other. Paragraph BC33(b) of ASU 2016-10 states, in part:

[The evaluation of whether two or more promises in a contract are separately identifiable also considers the utility of the promised goods or services (that is, the ability of each good or service to provide benefit or value). This is because an entity may be able to fulfill its promise to transfer each good or service in a contract independently of the other, but each good or service may significantly affect the other’s utility to the customer. For example, in Example 10, Case C, or in Example 55, the entity’s ability to transfer the initial license is not affected by its promise to transfer the updates or vice versa, but the provision (or not) of the updates will significantly affect the utility of the licensed intellectual property to the customer such that the license and the updates are not separately identifiable. They are, in effect, inputs to the combined solution for which the customer contracted. The “capable of being distinct” criterion also considers the utility of the promised good or service, but merely establishes the baseline level of economic substance a good or service must have to be “capable of being distinct.” Therefore, utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some economic benefit from each one, the customer’s ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.
In a speech at the 2017 AICPA Conference on Current SEC and PCAOB Developments, Joseph Epstein, professional accounting fellow in the OCA, provided the following guidance on the identification of performance obligations — specifically, whether an entity’s promise to transfer a good or service to a customer is separately identifiable from other promises in the contract:

I’d also like to take this opportunity to remind registrants that in evaluating whether two or more promised goods or services each significantly affect the other (and, therefore, are highly interdependent or highly interrelated), registrants should not merely evaluate whether one item, by its nature, depends on the other. Rather, those goods or services should significantly affect each other. [Emphasis added, footnote omitted]

Sarah Esquivel, associate chief accountant in the OCA, elaborated on this topic in a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments. In her speech, Ms. Esquivel described a fact pattern related to the identification of performance obligations in a contract for the sale of off-the-shelf patent application software. The software enabled the customer to prepare patent applications and also allowed the customer to print out the applications so that they could be submitted by mail. In addition, the contract included a free, one-time service of electronically submitting a patent application to the appropriate government agency. Ms. Esquivel made the following comments on whether the electronic submission service and the software were sufficiently interdependent or interrelated to constitute a single performance obligation:

In this fact pattern, the service was a convenience to the customer, but it was not required . . . . In addition, the choice of whether or not to use the service did not significantly impact the utility of the software, and thus the identified promises did not significantly affect each other, and therefore were not highly interdependent or highly interrelated. As a result, OCA objected to the registrant’s conclusion that the promises in the contract comprised a single performance obligation. [Footnote omitted]

This example emphasizes the view that entities should not merely evaluate whether one item depends on the other (one-way dependency); rather, they should evaluate whether the goods or services significantly affect each other (interdependency, or two-way dependency).

In a speech at the 2019 AICPA Conference on Current SEC and PCAOB Developments, OCA Professional Accounting Fellow Susan Mercier expanded on those views presented at the previous AICPA Conferences on determining whether an entity provides a combined performance obligation of software and updates. In addition, Ms. Mercier provided commentary of the use of the term “solution”:

While I understand that the term “solution” is commonly used nomenclature, I would observe that the staff is not persuaded that promises should be combined into a single performance obligation simply because a registrant labels those promises as a “solution” that the “customer wants.” . . . I think that the notion of considering if the registrant’s combined output is greater than or substantively different from the sum of the parts is helpful in many cases. . . .

In [a recent] consultation, the registrant licenses software that allows its customers, application (“app”) developers, to build and deploy, and therefore monetize, their own apps on various third-party platforms. The third-party platforms include phones as well as home entertainment systems, which, as you can imagine, are frequently undergoing their own updates. The registrant’s software and updates ensure that the app built using the software is compatible with all platforms that it supports, both when the app is initially deployed on a platform and over time as that platform is updated. Therefore, the registrant partners with the third-party platforms to understand their timelines for internal updates so that the registrant can ensure compatibility by initiating corresponding updates to its software. Without these updates, the customer’s ability to benefit from the software would be significantly limited over the contract term.

Ultimately, the staff did not object to the registrant’s conclusion that the software and updates represent a single performance obligation. In the staff’s view, the registrant’s promises to provide the software and the updates are, in effect, inputs that together fulfill a single promise to the customer — that is, to continually be able to deploy and monetize content using third-party platforms of the customer’s choice in a rapidly changing environment — and that the updates are integral to maintaining the utility of the software. In other words, in this fact pattern, the staff thinks that the combined output (whether or not you label it a “solution”) is greater than, or substantively different than, the individual promises (that is, the software and the updates). [Footnotes omitted]
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.

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**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.
Chapter 5 — Step 2: Identify the Performance Obligations

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.

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.
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.
Chapter 5 — Step 2: Identify the Performance Obligations

ASC 606-10 (continued)

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.

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).
ASC 606-10 (continued)

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.

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).
Chapter 5 — Step 2: Identify the Performance Obligations

ASC 606-10 (continued)

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.

5.3.2.3.1 Assessing the Availability of Alternative Service Providers and Its Impact on the Identification of Performance Obligations

The illustrative examples in ASC 606 provide certain facts used to support a determination of whether a promised good or service is distinct and therefore a separate performance obligation. However, some facts may vary between examples while the conclusions are consistent. For instance, in Example 11, Case C (ASC 606-10-55-150A through 55-150D), one of the facts provided to support the conclusion that the equipment and installation services represent two performance obligations is that others can provide the installation services. However, in Example 11, Case E (ASC 606-10-55-150G through 55-150K), the conclusion that the equipment and specialized consumables are two performance obligations is reached even though the specialized consumables are not available from other entities. This is because the entity in the example would be able to fulfill each of its promises in the contract (i.e., each promise to provide an item of equipment and consumables) independently of the other promises.

If a good or service (e.g., installation service) is unavailable from alternative providers, or available from only a limited number of alternative providers, an entity is not precluded from considering the good or service a separate performance obligation. The unavailability of a good or service from alternative providers is a factor for an entity to consider in evaluating whether the good or service is distinct (and therefore a separate performance obligation), but that factor is not individually determinative (as noted in the examples cited above). Entities need to use judgment in evaluating whether a promise to provide a good or service, in addition to other goods or services, is capable of being distinct and is distinct within the context of the contract (i.e., separately identifiable) in accordance with ASC 606-10-25-19. In
making that determination, an entity may focus on why a good or service is or is not available from other providers, especially when evaluating the following factors in ASC 606-10-25-21 to conclude on whether the good or service is separately identifiable:

• Whether there is a significant service of integrating goods or services.
• Whether the good or service significantly modifies or customizes another good or service.
• Whether the good or service and one or more other goods or services are highly interdependent or highly interrelated.

For example, if an entity sells equipment and provides installation of that equipment, the determination of whether the installation services are available from another entity would be a factor to be considered in the evaluation of whether the installation is distinct within the context of the contract, but that factor alone would not be determinative. It is important for the reporting entity to consider why the installation is unavailable from (or available from only a limited number of) alternative providers to determine whether the installation is separately identifiable in accordance with ASC 606-10-25-21. For example, if the entity has a standard installation process that does not significantly customize or modify the equipment for the entity’s customer, the entity may conclude that the installation is separately identifiable regardless of whether there are no other installation providers or only a limited number of such providers. However, installation services that are unique and significantly modify or customize the equipment for the customer may suggest that the services are not separately identifiable and therefore are not distinct within the context of the contract.

5.3.2.3.2 Identifying Performance Obligations in Co-Branded Credit Card Arrangements

An entity (e.g., a retailer or an airline) may enter into a co-branded or private-label credit card arrangement with a financial institution under which the financial institution issues credit cards that bear the entity’s brand name or logo to individual consumers. In both co-branded and private-label credit card arrangements, the financial institution is issuing credit and operating the card on its own behalf. Under a private-label credit card arrangement, the credit card can be used to purchase goods or services from only the entity (the “sponsoring entity”). However, under a co-branded credit card arrangement, the credit card can be used to purchase goods or services from any merchant that accepts that type of credit card (e.g., MasterCard or Visa). When a cardholder uses a private-label or co-branded credit card to make purchases, he or she generally earns loyalty or rewards points that can be redeemed for free or discounted products or services from the sponsoring entity.

Under co-branded credit card arrangements, the sponsoring entity usually has various obligations to the financial institution, including:

• Licensing its brand name (for use on the credit card and marketing materials).
• Providing access to its customer list (for marketing purposes).
• Marketing the credit card program.
• Providing products or services (or discounts on products or services) as part of a loyalty or rewards program.
• Maintaining the loyalty or rewards program.
The sponsoring entity in a co-branded credit card arrangement generally receives some combination of (1) an up-front or incentive fee upon executing the credit card arrangement (such as a signing bonus), (2) a fee for each new cardholder who signs up for a credit card (sometimes referred to as a “bounty fee”), (3) a specified percentage of the cardholders’ annual purchases or program profits, and (4) reimbursements from the financial institution for certain costs, such as products or services provided under the rewards program, marketing expenses, or other related expenses (such as credit card processing fees).

A sponsoring entity should carefully evaluate its contractual arrangement with a financial institution when identifying its performance obligations, as described more fully in the sections below.

5.3.2.3.2.1 Identifying the Promised Goods or Services in Co-Branded Credit Card Arrangements

The first step in the evaluation is to identify all of the promised goods or services in the contract. A typical co-branded credit card arrangement consists of the following promised goods or services:

• License of brand name.
• Access to customer list.
• Marketing activities.
• Maintaining the loyalty or rewards program.

Although the sponsoring entity has an obligation to maintain the loyalty or rewards program, maintenance activities related to the loyalty or rewards program generally do not constitute a promised good or service in the arrangement. Rather, the maintenance and administration of the loyalty or rewards program are typically activities that a sponsoring entity undertakes to fulfill its contract with the financial institution (specifically, its obligation to license its brand name and provide access to its customer list). That is, having a loyalty or rewards program makes the sponsoring entity’s brand name more valuable to the financial institution because individuals are more likely to sign up for the credit card when they know that they can earn loyalty or rewards points and redeem them with the sponsoring entity. In addition, sponsoring entities generally maintain a loyalty or rewards program for purposes other than the fulfillment of their credit card arrangements and therefore would undertake these activities even without entering into a contract with a financial institution. Therefore, we generally do not believe that these activities transfer a separate good or service to the financial institution.

5.3.2.3.2.2 Identifying the Performance Obligations in Co-Branded Credit Card Arrangements

The next step in the evaluation is to identify which of the promised goods or services in the contract represent distinct performance obligations. In general, we believe that a co-branded credit card arrangement such as the one described above contains at least two performance obligations: (1) a license bundled with access to the sponsoring entity’s customer list (the “brand performance obligation”) and (2) an obligation to provide products or services in the future for free or at a discount (the “rewards performance obligation”). On the basis of the entity’s assessment, marketing the credit card program may constitute a performance obligation of its own or may be combined with the brand performance obligation.
Considerations relevant to the determination of which promised goods or services in a co-branded credit card arrangement are distinct (i.e., capable of being distinct and separately identifiable) are as follows:

- **Brand performance obligation** — Generally, the right to use an entity's brand name is not sold separately from access to the entity's customer list. Nevertheless, we believe that both the license of the sponsoring entity's brand name and access to the sponsoring entity's customer list are capable of being distinct because the financial institution could benefit from each one in conjunction with other readily available resources. That is, the sponsoring entity could sell each item separately, and the financial institution could separately perform the other activities (marketing and supply of products or services) on its own to derive economic benefits from the arrangement. However, we do not believe that the license to the brand name and the customer list are separately identifiable because the license and access to the customer list are highly interdependent.

  Generally, a significant portion of the value to the financial institution in this type of arrangement comes from the financial institution's right to market to the sponsoring entity's loyalty or rewards members, which is provided through access to the sponsoring entity's customer list. In addition, strong brand recognition is intended to entice potential customers to enter into an arrangement with the financial institution for the co-branded credit card. Therefore, the value of the two items combined significantly exceeds the sum of the values that could be ascribed to the two individually. That is, the brand and access to the sponsoring entity's customer list are highly interdependent.

- **Rewards performance obligation** — The rewards performance obligation represents the sponsoring entity's obligation to honor a cardholder's redemption of loyalty or rewards points for free or discounted products or services in the future that are provided to the cardholder in connection with entering into a credit card agreement with the financial institution or through the use of the co-branded credit card. We believe that in this context, the rewards performance obligation could be accounted for in the same manner as a material right, which an entity is required to treat as a separate performance obligation under ASC 606-10-55-41 through 55-45. While we recognize that this obligation is technically to the customer's customer (i.e., the cardholder) rather than the customer itself (i.e., the financial institution), we believe that the same principle applies since the sponsoring entity is promising the financial institution that it will provide and redeem the loyalty points. That is, the sponsoring entity is committed to providing goods or services in the future for free or at a discount, and accounting recognition should be given to this obligation. In some cases, the sponsoring entity may be separately selling loyalty points to the financial institution, whereas in other cases, the sponsoring entity grants the financial institution the right to issue loyalty points on its behalf. In both types of situations, the sponsoring entity has essentially granted the financial institution the right to provide loyalty or rewards points to cardholders on the basis of their spending level, and we believe that this right is appropriately accounted for as a separate performance obligation.

- **Marketing activities** — Many co-branded credit card arrangements include some element of marketing activities. We believe that the marketing activities performed by the sponsoring entity typically are capable of being distinct because other entities (e.g., marketing agencies) regularly sell similar services on a stand-alone basis. In addition, the financial institution is able to benefit from these services along with other resources that have already been obtained from the sponsoring entity (i.e., the brand performance obligation). However, careful evaluation of the nature of marketing activities is required to determine whether they represent a separate performance obligation. For example, there may be certain marketing activities that only the entity is capable of providing (e.g., promotion of the card by sales personnel at the time of
identify the Performance Obligations in a Cloud Computing Arrangement That Includes Implementation Services

Entities that sell a cloud-based or hosted software solution (e.g., in a software-as-a-service (SaaS) arrangement) often include implementation services. These services are performed either (1) at the outset of the customer arrangement or (2) during the SaaS term (in many cases because of added modules or features of the SaaS solution). Depending on the facts and circumstances of the arrangement, an entity may need to use judgment to determine whether the implementation services represent (1) activities that do not transfer a good or service to the customer, (2) a promise that is not distinct from the SaaS, or (3) a distinct performance obligation.

5.3.2.3.3.1 Identifying Whether Implementation Services Are a Promised Good or Service

ASC 606-10-25-17 states the following regarding the identification of promised goods or services in an arrangement:

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.

In addition, ASC 606-10-55-53 states:

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.

Further, paragraph BC93 of ASU 2014-09 indicates that even if an activity is "required to successfully transfer the goods or services for which the customer has contracted," that activity may not "directly transfer goods or services to the customer."

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6 In this publication, it is assumed that a SaaS arrangement is accounted for as a service contract because the customer does not have the ability to take possession of the underlying software license on an on-premise basis.
7 If a customer purchases additional implementation services after the SaaS term has commenced, the entity would generally apply the modification guidance in ASC 606 and perform the same analysis as if it were analyzing implementation services purchased up front. For additional information about the accounting for contract modifications, see Chapter 9.
Implementation Q&A 48 (compiled from previously issued TRG Agenda Papers 41 and 44) contains an example in which the FASB staff discusses up-front implementation services that are provided with a SaaS solution. In the example, (1) the hosting period begins when the implementation services are complete and the customer cannot access or use the service until that time, (2) the vendor’s solution is proprietary and no other vendors can provide the implementation services, (3) the customer cannot derive any benefit from the implementation services or the SaaS until implementation is complete, and (4) the implementation services are not capable of being distinct from the hosting services. While the example is intended to illustrate considerations related to whether the implementation services were relevant to an entity’s measurement of progress toward completion of a performance obligation, it also addresses whether such implementation services would represent a performance obligation at all. According to the FASB staff, “the nature of the entity’s overall promise is the hosting service and the implementation service does not transfer a service to a customer”; thus, the services would be disregarded in a manner similar to the treatment of the set-up activities described in ASC 606-10-25-17. This view is analogous to that discussed in Example 53 in ASC 606-10-55-358 through 55-360, in which set-up activities related to transaction processing services “do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation.”

Since the nature and composition of implementation services can vary in practice, we do not believe that the example in Implementation Q&A 48 was intended to address all types of implementation services. Accordingly, an entity would have to carefully analyze the facts and circumstances of its SaaS arrangements and related implementation services to determine whether the activities a vendor performs for implementation services (1) transfer a good or service to the customer or (2) are akin to set-up activities. The entity’s analysis would be based on whether the customer obtains control of the implementation services as they are performed. In the determination of whether the customer obtains such control, we believe that it may be helpful for the entity to consider the following:

- Whose assets are being enhanced, improved, or customized by those activities. If the implementation activities are performed on the entity’s internal infrastructure and applications (i.e., “behind the firewall”), the activities most likely do not transfer a good or service to the customer and the entity therefore would not consider the services in identifying performance obligations. This would be the case even if the customer benefits from the implementation activities. Because the activities are performed on the entity’s assets, the entity retains control of any benefits those activities confer. By contrast, if the implementation activities are performed on the customer’s infrastructure and applications, the activities may represent the transfer of a promised good or service to the customer. Paragraph BC129 of ASU 2014-09 discusses “situations in which an entity’s performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced.” It states, in part:

> In those cases, because the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing . . . . For example, in the case of a construction contract in which the entity is building on the customer’s land, the customer generally controls any work in process arising from the entity’s performance.

- Whether the services are provided directly to the customer (i.e., the services are simultaneously received and consumed by the customer; another entity would not need to substantially reperform the entity’s performance to date). Paragraph BC125 of ASU 2014-09 states, in part:

> In many typical “service” contracts, the entity’s performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In those cases, the simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity’s output as the entity performs . . . . For example, consider an entity that promises to process transactions on behalf of a customer. The customer simultaneously receives and consumes a benefit as each transaction is processed.
Chapter 5 — Step 2: Identify the Performance Obligations

To the extent that the activities do not transfer a good or service to the customer, they should not be considered in the identification of performance obligations. See Section 8.9.4.1 for considerations related to the recognition of fees that may have been contractually assigned to activities that do not result in the transfer of a promised good or service to the customer.

**Example 5-3**

Company S enters into a nongancelable SaaS arrangement with Customer T for a three-year term. As part of the arrangement, S has agreed to perform certain activities to add functionality to the SaaS before the commencement of the contract term (i.e., customization services) for an incremental fee. The added functionality is needed for the SaaS to work as intended by T. To perform the customization services, S must make modifications to its software applications that will be used to provide the SaaS. Customer T can only access the added functionality through the SaaS and has no other rights to the enhancements. That is, S continues to retain ownership of the improvements.

The customization services are not promised goods or services to the customer. Since the customization services will take place behind the firewall, the functionality is added only to S’s assets, which S controls. The services will not enhance, improve, or customize a customer-controlled asset. Therefore, the arrangement does not result in a promise to transfer (i.e., does not transfer control of) services to the customer and would not be assessed as a promise under the contract. Rather, the customization services would be akin to set-up activities as described in ASC 606-10-25-17.

**Example 5-4**

Assume the same facts as in Example 5-3 except that S has also agreed to perform other implementation activities before the commencement of the contract term (i.e., implementation services) for an incremental fee. These activities, which are performed on T’s assets, include adapting and configuring T’s infrastructure and T’s in-place systems for communication with S’s infrastructure. In addition, S will convert and migrate T’s data in a format that is compatible with the SaaS platform and train T’s employees in the SaaS’s optimal use.

In this scenario, the additional implementation services are promised goods or services to the customer. Most of the activities enhance, improve, or customize T-controlled assets (i.e., T’s infrastructure, in-place systems, and data). In addition, the training is provided directly to T’s employees (as opposed to S’s employees), which permits T to simultaneously receive and consume the benefit conferred by the training. Therefore, the implementation services represent promises to transfer services to the customer and should be assessed as such under the contract.

**5.3.2.3.3.2 Identifying Whether Implementation Services Are a Distinct Performance Obligation**

If an entity has determined that implementation services represent promised goods or services to the customer, it would next assess whether such services and the SaaS are (1) each a distinct performance obligation or (2) a combined performance obligation. Under ASC 606-15-10-25-19, for a promised good or service to be a separate performance obligation, the promise must be both (1) capable of being distinct (i.e., 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) and (2) distinct within the context of the contract (i.e., the entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract).
We believe that the following factors (not all-inclusive) may be helpful in an entity’s determination of whether implementation services are a distinct performance obligation (the analysis may in some circumstances need to be performed separately for each promise because implementation services often consist of multiple activities that represent separate promises):

- **Whether the entity or other entities (e.g., consulting firms, SaaS competitors) provide the implementation services on a stand-alone basis** — We believe that this is a key consideration in the entity’s assessment of whether the implementation services are distinct. For example, if the entity has a number of partnerships or alliances with other organizations that enable those other businesses to provide the implementation services to the entity’s customers, the implementation services are likely to be distinct.

- **Whether the implementation services will provide an asset or incremental benefit to the customer without the SaaS arrangement (i.e., alternative use)** — An entity would evaluate whether the implementation services (1) are specific to the SaaS arrangement or (2) can be leveraged by the customer for use in other SaaS arrangements or circumstances. For example, an entity may provide professional services that enable the customer to use the SaaS to more efficiently analyze data. If those same professional services can be applied to other competitors’ SaaS solutions, the services may be distinct.

- **Whether the customer must obtain the implementation services to use and benefit from the SaaS arrangement (i.e., whether the SaaS is functional without the implementation services)** — An entity would evaluate whether the customer can maintain a reasonable degree of utility of the SaaS without the implementation services. For example, a SaaS that has no utility or value without the entity’s implementation services may be an indicator that the implementation services are not distinct.

- **Whether there are instances in which the SaaS was provided to customers without implementation services** — Customers’ frequent purchasing of the entity’s SaaS without purchasing its implementation service may be an indicator that the implementation services are distinct.

- **Whether the implementation services significantly alter any features or functionality of the SaaS** — For example, the implementation services may include significant customization of the customer’s infrastructure and applications to enable the SaaS to process transactions it could not process otherwise. Such customization may be an indicator that the implementation services are not distinct; however, if the customization’s benefits could be applied to another SaaS platform (i.e., another readily available resource), the implementation services may be distinct.

- **Whether the implementation services and the SaaS are so significantly integrated, interrelated, or interdependent that the entity could not fulfill its promises to transfer the implementation services and the SaaS independently** — For example, to enable the SaaS to perform unique functions that are critical to the customer’s intended use of the SaaS, the implementation services may require significant customization of both the entity’s and the customer’s systems. In such cases, the implementation services may not be distinct because there is likely to be an interdependency between the implementation services and the SaaS (i.e., as a result of the services, there is an enhancement to the combined functionality of the SaaS and the customer’s systems). In addition, as discussed in Section 5.3.2.3.3.1, the customization of the entity’s systems is not likely to be a promised good or service in the arrangement.
• Whether using the SaaS or providing implementation services requires a highly specialized or complex skill set that neither the customer nor third parties possess — For example, an entity may provide to a governmental agency a highly customized and complex SaaS solution that requires the entity to employ scientists. If there is significant risk associated with the entity’s ability to provide the implementation services and the level of effort and time needed to complete them is extensive, the implementation services may not be distinct. By contrast, if it is not difficult to configure or set up the customer’s systems and interfaces, the implementation services may be distinct.

• Whether the entity markets the implementation services and the SaaS as a combined solution — While marketing the services and SaaS in such a manner is not a determinative factor, it may support a conclusion that the implementation services are not distinct.

5.3.3 Series Guidance

As previously noted, ASC 606-10-25-14 provides the following guidance on what constitutes a performance obligation:

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| **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). |

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 certain 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. Further, the ASU’s Background Information and 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.

The following guidance in ASC 606-10-25-15 clarifies the meaning of “the same pattern of transfer”:

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| **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.
5.3.3.1 Determining Whether Distinct Goods or Services Are Substantially the Same

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), 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.

This issue is addressed in Implementation Q&A 18 (compiled from previously issued TRG Agenda Papers 39 and 44). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

5.3.3.1.1 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, as illustrated in the example below.

**Example 5-5**

**Monthly Cleaning Services**

Company A provides Customer Z monthly cleaning services for one year. Company A has been contracted to clean Z's offices once a month, for a total of 12 cleaning services in a year. Company A concludes that each monthly service (1) is distinct, (2) meets the criteria for recognizing revenue over time, and (3) uses the same method for measuring progress. In addition, A concludes that the cleaning services each month are substantially the same and result in the transfer of substantially the same service (office cleaning) to the customer each month. Therefore, A concludes that the monthly cleaning services satisfy the requirements of ASC 606-10-25-14(b) to be accounted for as a single performance obligation.

5.3.3.1.2 Undefined Services Over a 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 examples below.
Example 5-6

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 uses 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 5-7

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 uses 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.

5.3.3.2 Mandatory Treatment of a Series of Distinct Goods or Services as a Single Performance Obligation

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. If an entity concludes that a series of distinct goods or services meets the requirements of ASC 606-10-25-14(b), it is required to treat that series as a single performance obligation (i.e., it cannot choose to regard the distinct goods or services in the series as individual performance obligations). 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).
5.3.3.3 Other Issues Related to the Determination of Whether the Series Guidance Applies

In discussion with the TRG, the FASB staff 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 staff 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.
- 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 staff noted that it does not believe that the accounting result needs to be "substantially the same." Further, the staff stated that "[s]uch a requirement would almost certainly make it more difficult for entities to meet the requirement, and because 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."\(^8\)

5.3.3.3.1 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).

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 Background Information and Basis for Conclusions of ASU 2014-09, the FASB staff noted that it "does not think whether the pattern of performance is consecutive is determinative to whether the series provision applies."\(^9\) That is, goods or services do not need to be transferred consecutively to qualify as a series of distinct goods or services under ASC 606-10-25-14(b) and, specifically, to have the “same pattern of transfer to the customer.”

\(^8\) Quoted from Implementation Q&A 20 (compiled from previously issued TRG Agenda Papers 27 and 34).
\(^9\) Quoted from Implementation Q&A 19 (compiled from previously issued TRG Agenda Papers 27 and 34).
As noted in Section 5.3.3, 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 lists 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 above issue is addressed in Implementation Q&A 19 (compiled from previously issued TRG Agenda Papers 27 and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

5.3.3.3.2 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

The application of ASC 606-10-25-14(b) does not have to produce the same accounting result as treating each distinct good or service as a separate performance obligation.

The above issue is addressed in Implementation Q&A 19 (compiled from previously issued TRG Agenda Papers 27 and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

5.3.3.4 Illustrative Example of a Series of Distinct Goods or Services (ASC 606-10-55-157B Through 55-157E)

Example 12A in ASC 606, which is reproduced below, further discusses the accounting for a series of distinct goods or services.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 12A — Series of Distinct Goods or Services</td>
</tr>
<tr>
<td><strong>55-157B</strong> 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.</td>
</tr>
</tbody>
</table>
### ASC 606-10 (continued)

**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.

**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.

**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.

### 5.3.3.5 Application of the Series Provision in Life Sciences Arrangements

Entities in the life sciences industry may enter into service arrangements with other entities in the industry as part of their product development process. For example, the developer of a drug compound or other IP may enter into an arrangement with an entity that agrees to provide it with clinical outsourcing support services ("R&D services"). These R&D services may involve various tasks such as patient enrollment, clinical trial site management, and activities related to regulatory filings. While the two entities agree to a set of objectives, the entity providing the R&D services may not promise or guarantee an end result. Instead, the entity providing the R&D services satisfies its performance obligation by making available access to clinical professionals to advance the R&D efforts toward agreed-upon objectives. Given the nature of such R&D services, the services may not be performed consistently or consecutively over the service period, and their nature and scope may change as the work progresses.
An entity's application of ASC 606 to a contract with a customer may be affected by whether the entity determines that its promises to the customer represent (1) a single combined performance obligation comprising multiple activities that are not distinct or (2) a single performance obligation consisting of a series of distinct increments. Specifically, the application of the guidance on allocating variable consideration, accounting for contract modifications, and providing disclosures related to remaining performance obligations differs for a series of distinct increments of goods or services. We believe that the determination of whether R&D services provided by entities in the life sciences industry represent a series may require significant judgment.

The first step in the evaluation of whether an entity's promise to provide R&D services to a customer represents a series is to assess whether the nature of the promise is one of the following:

- The delivery of a specified quantity of goods or services.
- A stand-ready obligation to provide an indefinite amount of goods or services during a specified period.

If the nature of the promise is to deliver a specified quantity of goods or services, the entity must determine whether each good or service is distinct, is substantially the same as the other goods or services, and has the same pattern of transfer to the customer as that of the other goods or services.

If, on the other hand, the nature of the promise is to stand ready for a specified period, the entity must determine whether, for each increment of time, its promise of standing ready to provide the R&D services is distinct, is substantially the same as its promise for each of the other increments of time, and has the same pattern of transfer to the customer as its promise for each of the other increments of time.

Contracts in the life sciences industry to perform R&D services appear in various forms. For example, some contracts may include a license to IP in addition to the R&D services. If it is determined that the license and the R&D services are both within the scope of ASC 606 but are not distinct promises (or if the customer already has control of a license and the entity's only promise in the contract is to provide R&D services), the series guidance may not apply to the combined performance obligation if the R&D services provided throughout the development period are cumulative in that each increment of service builds on and is dependent on the increments that precede it (i.e., such services would not be considered distinct within the context of the contract). In such a case, the R&D services would generally be accounted for as a single combined performance obligation consisting of multiple activities that are not distinct, as opposed to a series of distinct increments of time or service. In certain other cases, R&D services may meet the criteria to be accounted for as a series, as illustrated in the example below.

**Example 5-8**

CRO, a contract research organization, enters into an arrangement with Pharma, the developer of a new drug compound, to perform daily R&D services for Pharma as needed during phase 3 clinical trials by giving Pharma access to clinical professionals. In exchange for the R&D services provided to Pharma, CRO will receive a daily fee per person and success-based milestone payments.

The activities to be performed may vary each day as CRO and Pharma work toward agreed-upon objectives in connection with the phase 3 clinical trials. While the activities may vary by day, they represent fulfillment activities associated with providing the daily R&D services and do not represent separate promises in the arrangement. Further, CRO has determined that such services are readily available in the marketplace and are not cumulative because each day's research and corresponding results are not dependent on the prior day's research; thus, each day of services does not build on activities that precede it, and each day of services and the activities that precede it are not integrated, interdependent, or interrelated. That is, no day of services significantly affects either CRO's ability to fulfill another day of services or the benefit to Pharma of another day of services.
Example 5-8 (continued)

CRO determines that Pharma is a customer within the context of providing the services and therefore likewise concludes that the services are within the scope of ASC 606. In addition, CRO determines that the services to be provided to Pharma meet the criteria in ASC 606-10-25-27(a) for recognition of revenue over time since the services performed during each increment of time contribute to Pharma's development of the drug compound and thereby allow Pharma to simultaneously receive and consume the benefits provided by CRO's performance as each task is performed.

Nature of the Promise

CRO determines that the nature of its promise is to stand ready to provide daily R&D services as needed during phase 3 clinical trials. Accordingly, CRO must assess whether, for each increment of time, its promise of standing ready to provide the R&D services (1) is distinct, (2) is substantially the same as its promise for each of the other increments of time, and (3) has the same pattern of transfer to the customer as its promise for each of the other increments of time.

Distinct

Pharma benefits from each day of services on its own since the services contribute to Pharma's development of the drug compound and are readily available in the marketplace. Consequently, CRO concludes that each increment of services is capable of being distinct.

In addition, CRO determines that each increment of services is distinct within the context of the contract. This is because each day of services (1) does not significantly modify or customize another day of services and (2) does not significantly affect CRO's ability to fulfill another day of services or the benefit to Pharma of another day of services since the R&D services are not cumulative, as noted above.

Substantially the Same

CRO determines that for all of the increments of time during which R&D services are performed, its promise of standing ready to perform those services is substantially the same. While the specific tasks or services performed during each increment of time will vary, the nature of the overall promise to provide Pharma with daily R&D services remains the same throughout the contract term.

Same Pattern of Transfer

CRO determines that the services have the same pattern of transfer to Pharma because both criteria in ASC 606-10-25-15 are met. The criterion in ASC 606-10-25-15(a) is met because each distinct service meets the criteria in ASC 606-10-25-27 to be a performance obligation satisfied over time since Pharma simultaneously receives and consumes the benefits provided by CRO as CRO performs. The criterion in ASC 606-10-25-15(b) is met because the same measure of progress (in this case, a time-based output method) would most likely be used to measure the progress of CRO toward satisfying its promise to provide the daily R&D services.

Conclusion

On the basis of the above, CRO concludes that the R&D services are a series and accounts for them accordingly.

Connecting the Dots — Determining When to Recognize Revenue for R&D Services That Are Not Accounted for as a Series

It is common in the life sciences industry for an entity to transfer a license of IP along with R&D services to the customer as a single performance obligation. The license may not be capable of being distinct without the R&D services. That is, the R&D services performed by the entity may be novel, requiring the entity to provide the R&D services for the customer to benefit from the license. In determining when revenue should be recognized for the single performance obligation with two promised goods (the delivery of the license and R&D services), the entity must determine whether the single performance obligation is satisfied over time or at a point in time. In this type of transaction, the criteria in ASC 606-10-25-27(a) and (b) for recognizing revenue over time may be met. The entity can conclude that the criterion in ASC 606-10-25-27(a) is met if it determines that the work that it has completed to date (related to the R&D services)
would not need to be substantially reperformed by another entity if the other entity were to step in and fulfill the remaining performance obligation to the customer (since this would mean that the customer simultaneously receives and consumes the benefits provided by the entity’s performance of the R&D services as the entity performs those services). In addition, the entity can conclude that the criterion in ASC 606-10-25-27(b) is met if it determines that (1) the customer obtains control of the license (i.e., the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the license) and (2) the R&D services provided will simultaneously enhance the license.

For additional information specific to the life sciences industry, see Deloitte’s *Life Sciences Industry Accounting Guide*.

### 5.3.4 Identifying Performance Obligations in Real Estate Sales

Sometimes, a seller remains involved with property that has been sold. Under the legacy guidance in ASC 360-20, 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. ASC 360-20 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 control of the related good or service to the customer.

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 control of 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.

### Connecting the Dots — Common Areas and Other Amenities in a Community Development

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.

Connecting the Dots — Phases of Engineering, Design, Procurement, and Construction

Construction and engineering entities often enter into contracts that include promises 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 interdependent and highly interrelated or part of a significant service of integration) or are distinct performance obligations.

Such difficulty may affect the way revenue (or other gains or losses, if the transaction is with a noncustomer) is 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.

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.

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 faithfully 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 Impact of Exclusivity on the Identification of Performance Obligations

Certain contracts with customers may include conditions related to exclusivity that restrict the entity’s ability to sell goods or services to other customers or in certain geographies. The exclusivity may be limited in time or may be indefinite.
For example, an entity may provide a customer with an exclusive license of IP, thus preventing the entity from issuing licenses of that IP to other customers. Alternatively, an entity may enter into an exclusive distribution arrangement to provide goods or services to a customer in a specific geographical area, thereby limiting the entity's ability to sell goods or services to other customers in that geographical area.

Generally, it is not appropriate to identify exclusivity as a performance obligation in a contract with a customer.

In paragraph BC412(b) of ASU 2014-09, the FASB and IASB discussed the effect of exclusivity clauses in the context of licenses of IP. They acknowledged that many respondents to the boards' 2010 exposure draft on revenue “explained that a distinction based on exclusivity was inconsistent with the control principle because exclusivity does not affect the determination of the entity's performance.” In addition, the boards noted that “exclusivity is another restriction that represents an attribute . . . rather than the nature of the underlying intellectual property or the entity's promise in granting a license.” As a result, exclusivity is not accounted for separately in a license arrangement.

Although the discussion above was in the context of licenses of IP, the comments made are equally valid in the context of other goods and services. Accordingly, exclusivity would generally be seen as an attribute of the goods or services supplied, as opposed to a separate promise in itself, because exclusivity does not affect the nature of the entity's performance to provide the underlying goods or services.

5.4.3 Stand-Ready Obligations

Contracts promise specific goods and services, but sometimes they also promise to deliver those goods and services over a specified period. 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 (e.g., snow removal during the winter) is available to the customer when and if needed or called upon. 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. In this type of arrangement, (1) a customer may 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, or (2) the delivery of some or all of the goods and services on a when-and-if-available basis may be in the control of the entity.

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 IP is required (“Type A”).
- Outside both the entity's and the 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 measuring progress toward completion of a stand-ready obligation in the new revenue standard10 (“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

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10 ASC 606-10-55-184 through 55-186.
health club and (2) the entity stands ready to make 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).

Entities will need to use judgment when evaluating arrangements that have characteristics of Types A through C as described above. Section 5.4.3.1 (below) and Section 5.4.3.2 provide additional guidance to help entities make the necessary judgments.

5.4.3.1 Assessing Whether a Promise Is a Stand-Ready Performance Obligation

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 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 updates and upgrades** — An entity promises to make unspecified (i.e., when-and-if-available) software updates and upgrades available to a customer, and the entity has no discernible pattern of providing updates and upgrades. The nature of the entity's promise is fundamentally one of providing the customer with assurance that any updates or upgrades 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. For further discussion, see Connecting the Dots below.
See Section 8.5.10 for additional considerations on measuring progress toward the complete satisfaction of a stand-ready obligation that is satisfied over time.

The above issue is addressed in Implementation Q&A 22 (compiled from previously issued TRG Agenda Papers 16 and 25). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

**Connecting the Dots — Determining Whether a Maintenance Contract Includes a Stand-Ready Obligation**

In Implementation Q&A 22, the FASB staff discusses maintenance contracts under which a customer would receive repair or maintenance services as needed over a prescribed period. The Q&A states the following:

The staff thinks that whether the obligation is to provide a defined good or service (or goods or services), or instead, to provide an unknown type or quantity of goods or services might be a strong indicator as to the nature of the entity's promise in the contract. The staff notes, however, that in either case the entity might be required to “stand ready” to deliver the good(s) or service(s) whenever the customer calls for them or upon the occurrence of a contingent event (for example, snowfall).

If an entity has entered into maintenance contracts to provide maintenance services on equipment only on an as-needed basis, it may be appropriate for the entity to account for its performance obligations under those contracts as stand-ready obligations by recording revenue as the stand-ready services are provided. However, the entity must evaluate its contracts that include maintenance goods or services to determine the nature of its promises on the basis of the specific facts and circumstances of each contract.

Assessing whether the promise in a maintenance contract is a stand-ready obligation will require judgment. However, an entity may consider indicators supporting a conclusion that a stand-ready obligation does not exist. Such indicators include, but are not limited to, the following:

- The contract contains a promise to provide services that is specific about amounts and timing, as opposed to a promise to provide services as needed.
- The services vary in nature, frequency, or complexity each time they are performed.
- The goods or services are highly integrated or interrelated as a result of the complexity involved in providing them, making it difficult for another entity to take over the maintenance services.
- Modifications to the contract often include promises for specific additional goods or services.

If an entity concludes that it does not have a stand-ready obligation, it would account for the goods or services on the basis of the specific promises in the contract.

**5.4.3.2 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.
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 to them. [Emphasis added]

**Example 5-9**

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 **Section 8.5.10** for an additional illustration of this distinction.
Chapter 5 — Step 2: Identify the Performance Obligations

5.4.3.3 Unspecified Future Goods or Services in a Software Arrangement — Timing of Revenue Recognition

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. A common example of this situation arises in software contracts.

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 updates and upgrades to the software on a “when and if available” basis. The unspecified updates and upgrades are different from, and extend beyond, an assurance-type warranty.

When a contract with a customer transfers the rights to unspecified future updates, 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 specified 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.

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 that 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.

11 The nature of the entity’s promise when it commits to provide unspecified updates and upgrades to a customer differs from the entity’s obligation when it commits to deliver specified upgrades. This discussion addresses only unspecified updates and upgrades. For specified upgrades, the analysis will most likely be different since specified upgrades will often be a separate performance obligation.
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 the 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.

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.
The decision tree below illustrates the new revenue standard’s process for determining whether a warranty represents a separate performance obligation.

An entity may need 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.
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.

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.

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 in March 2015 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 that 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.”

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.

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12 Quoted from *Implementation Q&A 17*. 

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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.

**Example 5-10**

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 5-11**

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 above issue is addressed in Implementation Q&A 17 (compiled from previously issued TRG Agenda Papers 29 and 34). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

### 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 insurance entity. Further, a warranty could be within the scope of the guidance on guarantees in ASC 460-10 if it provides assurance that a product complies with agreed-upon specifications, 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.
Example 44 in ASC 606 illustrates how to account for an assurance-type 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.

### 5.5.5 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.
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.

**Example 5-12**

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.

### 5.6 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 in 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.

### Changing Lanes — No Real Change From Legacy 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 legacy revenue guidance. Historically, SAB Topic 13 includes specific rules related to the recognition of revenue from nonrefundable up-front fees. However, under both legacy 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.

Example 5-13 below illustrates how an entity would determine the period over which to recognize a nonrefundable up-front fee.

### Example 5-13

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.

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).
Example 5-13 (continued)

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 above issue is addressed in Implementation Q&A 52 (compiled from previously issued TRG Agenda Papers 18, 25, 32, and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

Refer to Section 8.9.4 for additional discussion of the accounting for nonrefundable up-front fees.
Chapter 6 — Step 3: Determine the Transaction Price

6.1 Overview
6.2 Fixed Consideration
6.3 Variable Consideration
6.4 Significant Financing Component
6.5 Noncash Consideration
6.6 Consideration Payable to a Customer
6.7 Sales Taxes and Similar Taxes Collected From Customers
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 approach 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 legacy 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.

Connecting the Dots — 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 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 Section 4.3.5 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
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).

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 (see Section 6.1.2 below).
6.1.2 Effect of a Customer’s Credit Risk on the Determination of the Transaction Price

When measuring the transaction price, an entity should take a customer’s credit risk into account only to determine (1) the discount rate used to adjust the promised consideration for a significant financing component, if any, and (2) potential price concessions.

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) unless a price concession is expected. 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 Section 6.4.5, 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 also 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 substantially all of the consideration to which the entity is entitled is probable (specifically, ASC 606-10-25-1(e)). See Section 4.3.5 for further discussion of how a customer’s credit risk affects an entity’s identification of its contract with the customer in step 1.

Changing Lanes — Comparison With Legacy Revenue Guidance

Legacy 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.

6.2 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 multiplied by 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

Legacy 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 6.4). 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 6.3, 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.

6.3 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.
Chapter 6 — Step 3: Determine the Transaction Price

ASC 606-10 (continued)

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

Under legacy 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. As a result of performing this assessment under the new revenue guidance, entities will most likely recognize revenue earlier than they did under legacy 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.

In addition, legacy 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.

The model in ASC 606 for measuring variable consideration is generally considered by financial statement users to be an improvement over legacy revenue accounting. Under ASC 606, there is 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.

As noted above, ASC 606 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.
6.3.1 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 $P \times Q$ is variable.

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1 Variable consideration would not need to be estimated if an entity is applying the invoice practical expedient to measure progress toward complete satisfaction of a performance obligation (see Section 8.5.8.1) or the variable consideration allocation exception in ASC 606-10-32-40 (see Section 7.5).
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 \( P \times Q = P \times (1,000 \times 12) = $60,000 \).

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.

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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.
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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, or expects, 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 Section 6.1.2, is generally not measured as part of the transaction price (except in the determination of the discount rate an entity should use when adjusting the transaction price for a significant financing component [see Section 6.4.4] or in the determination of potential concessions associated with credit risk [see Section 6.1.2]) 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, Section 4.3.5.2 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 6.3.5.1).
- Product returns and other customer credits (further discussed in Sections 6.3.5.2 and 6.3.5.3).
- Variable quantities and volumetric optionality (further discussed in Section 6.3.5.4).
- Rebates (volume-based rebates are further discussed in Section 6.3.5.4.2).
- Discounts (cash discounts are further discussed in Section 6.3.5.5.3; and volume discounts are discussed in Example 24 from ASC 606, which is included in Section 6.3.5.4.2).
- Performance-based bonuses or penalties (further discussed in the context of bonuses in Section 6.3.2.1; and also further discussed in the context of both bonuses and penalties and in Example 21 of ASC 606, which is included in Section 6.3.2.3).

### 6.3.2 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.

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<tr>
<th>ASC 606-10</th>
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<tbody>
<tr>
<td><strong>32-5</strong> 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.</td>
</tr>
<tr>
<td><strong>32-8</strong> 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:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td><strong>32-9</strong> 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.</td>
</tr>
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</table>
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 boards’ 2010 exposure draft on revenue (issued by the FASB as a proposed ASU), 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 Section 6.3.2.1 for further discussion of selecting the most appropriate method).

**Connecting the Dots — 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.

Although we think that it is appropriate for an entity to be pragmatic in deriving an estimate by using either the most likely amount method or the expected value method as required, 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.
6.3.2.1 Selection of Method Used to Estimate Variable Consideration

When determining the appropriate method for estimating variable consideration, an entity should choose 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 6-1

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 similar 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.

6.3.2.2 Using a Portfolio of Data Versus the Portfolio Practical Expedient When Applying the Expected Value Method

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 raised questions 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.
Example 6-2 below clarifies 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.

**Example 6-2**

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 Section 6.3.2.1 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.

In accordance with ASC 606-10-32-8, B should estimate variable consideration by using whichever method will better predict the amount of consideration to which it will become entitled. 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 Section 6.3.2.1). 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. 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.

It is important to highlight that in this example, B is not applying the portfolio practical expedient. 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. 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.

The above issue is addressed in Q&A 39 (compiled from previously issued TRG Agenda Papers 38 and 44) of the FASB staff's *Revenue Recognition Implementation Q&As* (the "Implementation Q&As"). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

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2 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.
6.3.2.3 Using More Than One Method to Estimate Variable Consideration Within One Contract

When a contract contains multiple elements of variability, an entity can 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. Example 21 in ASC 606-10-55-197 through 55-200 (reproduced below) 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.

**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 specified 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.

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.
Chapter 6 — Step 3: Determine the Transaction Price

Example 6-3

Entity X, an IT service provider, enters into a unique 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). Since the contract is unique, X does not have a pool of similar contracts from which to develop a portfolio of data it would need to use the expected value method.

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 an element of variable consideration and a 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 a unit of account identified in step 2 (see Chapter 5). The differentiation is intended to clarify that an estimate of variable consideration is performed for each incremental driver of variability 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 (unless the invoice practical expedient for measuring progress toward complete satisfaction of a performance obligation (see Section 8.5.8.1) or the variable consideration exception under ASC 606-10-32-40 (see Section 7.5) is applied.
6.3.3 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.

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<tr>
<td><strong>32-11</strong> 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.</td>
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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.”
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 6.3.2) 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 legacy, 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 list of differences between U.S. GAAP and IFRS Standards regarding revenue-related issues on which the boards could not converge, see Appendix A.

**Connecting the Dots — 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 6.3.5.1 and Chapter 12 for further discussion of sales- or usage-based royalties. Outside of these exceptions, an entity should include a minimum amount of variable consideration in the transaction price if management believes that this minimum amount is not constrained. While a minimum revenue amount stated in a contract may help an entity estimate this amount, management should not choose by default to make its estimate the minimum amount stated in the contract since there may be an amount of variable consideration in excess of that minimum for which it is probable that a significant reversal of revenue will not occur once the uncertainty is resolved.

Example 23 in ASC 606 (reproduced below) illustrates how an entity evaluates the constraint on estimates of variable consideration in the determination of the transaction price at the contract level.

**ASC 606-10**

<table>
<thead>
<tr>
<th>Example 23 — Price Concessions</th>
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<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
### 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).

**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 Codification 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 8.6.8.

### 6.3.3.1 Constraint on Variable Consideration Assessed at the Contract Level

As described in Section 3.1.2, 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 6-4

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 above issue is addressed in Implementation Q&A 30 (compiled from previously issued TRG Agenda Papers 14 and 25). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

#### 6.3.3.2 Estimating Multiple Elements of Variable Consideration and Assessing the Constraint on Variable Consideration

As stated in Section 6.3.2.3, Example 21 in ASC 606-10-55-197 through 55-200 shows that when a contract contains multiple elements of variability (e.g., sales returns, discounts, performance bonuses), 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. Since the revenue constraint forms part of the determination of the transaction price, the likelihood
and significance of a potential revenue reversal should be assessed at the contract level. Therefore, it is important for entities to be aware of the distinction between (1) preparing separate estimates for each element of variable consideration in a contract and (2) separately evaluating the constraint on estimates of variable consideration in the determination of the transaction price at the contract level.

Example 25 in ASC 606 (reproduced below) illustrates how an entity evaluates the constraint on estimates of each element of variable consideration in the determination of the transaction price at the contract level.

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**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.

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.
6.3.4 Evaluating the Impact of Subsequent Events on Estimates of Variable Consideration

In certain circumstances, the uncertainty related to variable consideration may be resolved shortly after the end of the reporting period. When additional information (e.g., regulatory approval notification or denial) is received after the end of the reporting period and before the date on which financial statements are issued or available to be issued, an entity should refer to the guidance in ASC 855 on accounting for subsequent events. Paragraph BC228 of ASU 2014-09 states the following:

The Boards noted that in some cases, an entity might make an estimate of the amount of variable consideration to include in the transaction price at the end of a reporting period. However, information relating to the variable consideration might arise between the end of the reporting period and the date when the financial statements are authorized for issue. The Boards decided not to provide guidance on the accounting in these situations because they noted that the accounting for subsequent events is already addressed in Topic 855, Subsequent Events, and IAS 10, Events after the Reporting Period.

ASC 855 distinguishes between recognized subsequent events (ASC 855-10-25-1) and nonrecognized subsequent events (ASC 855-10-25-3) as follows:

25-1 An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

25-3 An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. See paragraph 855-10-55-2 for examples of nonrecognized subsequent events.

In the life sciences industry, it is common for a life sciences entity to enter into a contract with a customer that entitles the life sciences entity to variable consideration in the event that the customer receives regulatory approval as a result of the R&D activities performed by the life sciences entity. Because the variable consideration is contingent on the customer’s receipt of regulatory approval, the life sciences entity is required to estimate the amount of variable consideration to include in the transaction price. The life sciences entity may conclude that such variable consideration should be constrained until regulatory approval is obtained.

However, ASC 855 does not provide direct guidance on how to account for additional information about regulatory approval or denial that is received after the end of the reporting period and before the date on which the financial statements are issued or are available to be issued. We believe that the conclusion to account for information received about the regulatory approval process as either a recognized or a nonrecognized subsequent event will be based on the facts and circumstances and may require significant judgment. Accordingly, entities are encouraged to consult with their accounting advisers.

6.3.5 Application to Different Forms of Variable Consideration

6.3.5.1 Sales- or Usage-Based Royalties

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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 12 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 12 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 6.3.2 and 6.3.3, 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).

### 6.3.5.2 Refund Liabilities

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>32-10</strong> 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.</td>
</tr>
</tbody>
</table>

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 in Section 6.3.5.3.

In addition, as discussed in Section 14.3, refund liabilities are to be presented separately from contract liabilities in the balance sheet. Refund liabilities would generally not be presented in Schedule II — Valuation and Qualifying Accounts as described in SEC Regulation S-X, Rules 5-04 and 12-09.

Presentation of refund liabilities is further discussed in Chapter 14.
6.3.5.3  Sales With a Right of Return

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.

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.

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 Section 5.2.4.2 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 legacy 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.
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.

6.3.5.3.1 Estimating the Transaction Price When an Entity Promises to Stand Ready to Accept a Returned Product During the Return Period and Provide a Refund

When an entity promises to stand ready to accept a returned product during the return period and provide a refund, 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. The entity should adjust that amount 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 Section 6.3.2.1).

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. This is illustrated by Example 22 in ASC 606-10-55-202 through 55-207, which is reproduced below.
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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000 ($100 × 100 products transferred)</td>
</tr>
<tr>
<td>Revenue</td>
<td>$9,700 ($100 × 97 products not expected to be returned)</td>
</tr>
<tr>
<td>Refund liability</td>
<td>$300 ($100 refund × 3 products expected to be returned)</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$5,820 ($60 × 97 products not expected to be returned)</td>
</tr>
<tr>
<td>Asset</td>
<td>$180 ($60 × 3 products for its right to recover products from customers on settling the refund liability)</td>
</tr>
<tr>
<td>Inventory</td>
<td>$6,000 ($60 × 100 products)</td>
</tr>
</tbody>
</table>

6.3.5.3.2 Accounting for 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.

Restocking fees for expected returns should be included in the transaction price. When accounting for restocking fees, an 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 6-5**

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.

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>910</td>
</tr>
<tr>
<td>Refund liability</td>
<td>90</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Products expected to be returned (asset)</td>
<td>70</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>680</td>
</tr>
<tr>
<td>Inventories</td>
<td>750</td>
</tr>
</tbody>
</table>
Example 6-5 (continued)

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refund liability</td>
<td>90</td>
</tr>
<tr>
<td>Cash (refund paid to customer)</td>
<td>90</td>
</tr>
<tr>
<td>Inventories</td>
<td>75</td>
</tr>
<tr>
<td>Products expected to be returned</td>
<td>70</td>
</tr>
<tr>
<td>Cash (payment of restocking costs)</td>
<td>5</td>
</tr>
</tbody>
</table>

The above issue is addressed in Implementation Q&As 42 and 77 (compiled from previously issued TRG Agenda Papers 35 and 44). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

6.3.5.4 Variable Consideration Driven by Variable Volumes

6.3.5.4.1 Distinguishing Between Optional Purchases and Variable Consideration

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 Chapter 11). 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.

The new revenue standard does not require or allow an entity to estimate the transaction price of future contracts into which it will enter with a customer. This assertion 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, an entity should 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. If an option to acquire additional goods or services 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). The 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.
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). Section 11.4 further expands on this view.

In contrast, 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. 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 variability because of other factors (e.g., variable quantities that affect the consideration due under the contract). Entities should consider the need to take variability of this nature into account in determining the transaction price.

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 single performance obligation for which the quantity of goods or services to be transferred is not fixed at the outset (which would give rise to 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, and the variability in transactions processed results in variable consideration.

The above issue is addressed in Implementation Q&A 23 (compiled from previously issued TRG Agenda Papers 48 and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

6.3.5.4.2 Volume-Based Rebates

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.
A volume rebate or discount that is **retrospectively** applied should be accounted for under ASC 606 as variable consideration (rather than as a customer option to be evaluated as a potential material right). 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).

However, an offer to **prospectively** lower the price per unit (once certain volume thresholds are met) should not be accounted for as variable consideration. Rather, when a volume rebate or discount is applied **prospectively**, an entity 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, the entity 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 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.

### 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).
Example 6-6

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).

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 6-7

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.

Example 6-8

Reassessment of Volume Discounts Applied Retrospectively

Assume the same facts as those in Example 6-6, as well as the following additional information:

- Entity X initially estimated total widget sales of 90 items. The $2 variable consideration was included in the transaction price because X believed that it was probable that a significant reversal in the amount of cumulative revenue recognized would not occur (i.e., it was likely that the customer would not purchase more than 100 units).
- Entity X sells 10 units during the first quarter, sells 20 units during the second quarter, and sells 60 units during the third quarter.
- In light of recent sales activity, X increases its estimate of total sales volume for the year to 120 units.
Example 6-8 (continued)

In this example, X will be required to effectively reduce the price per unit to $8. Accordingly, X should update its calculation of the transaction price to reflect the change in estimate. The updated transaction price is $8 per unit, which is based on the recent increase in sales activity and updated sales volume. Therefore, X should recognize revenue of $420 for the third quarter, which is calculated as follows:

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$8 per unit × 60 units sold during third quarter</td>
<td>$ 480</td>
</tr>
<tr>
<td>Less: $2 per unit ($10 – $8) × 30 units previously sold</td>
<td>(60)*</td>
</tr>
<tr>
<td>Total revenue recognized in third quarter</td>
<td>$ 420</td>
</tr>
</tbody>
</table>

* The cumulative catch-up adjustment reflects the revenue that X would have recognized if the sales volume information that is now available had been available to X at contract inception.

6.3.5.5 Other Forms of Variability

6.3.5.5.1 Contracts That Include Consideration in a Foreign Currency

Despite the broad definition of variable consideration in ASC 606, consideration that is fixed in a foreign currency (i.e., a currency other than the entity’s functional 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.

6.3.5.5.2 Variable Consideration in Real Estate Sales

A real estate sales contract may allow the seller to participate in future profits related to the underlying real estate. Under legacy 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. As discussed in Sections 6.3.2 and 6.3.3, 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.

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, revenue may sometimes be recognized earlier under the new revenue standard than under legacy U.S. GAAP.
For example, suppose that an entity 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 legacy U.S. GAAP, participation in the profit would be delayed until the homes are sold, profits are realized, and the entity is under no obligation to refund any amounts received to date. Under the new revenue standard, the entity 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 revenue (or other gains and losses, if the transaction is with a noncustomer) up front when the land is sold. Determining the amount of revenue that is not subject to a significant revenue reversal could require significant judgment.

Further, an entity that has entered into a real estate sales contract may need to consider whether the contract contains a significant financing component (see Section 6.4).

6.3.5.5.3 Cash Discounts for Early Payment

Cash discounts for early payment are a form of variable consideration. This is because the amount of consideration to which an entity is entitled in these arrangements depends on a customer’s actions (i.e., a customer’s decision to pay amounts due in time to take advantage of an early payment discount). Example 6-9 below illustrates how a seller would account for a cash discount it provides to a customer for making an early payment.

**Example 6-9**

Entity X offers Customer Y 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 Y pays within 30 days, Y will receive a 10 percent discount on the total invoice. Entity X sells a large volume of similar items on these credit terms (i.e., this transaction is part of a portfolio of similar items). Entity X 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.

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 X will be entitled is variable.

Therefore, X should recognize revenue when or as the performance obligation is satisfied net of the amount of cash discount expected to be taken. To determine the amount of revenue to be recognized, X should use either the “expected value” or the “most likely amount” method and consider the effect of the constraint.

For example, if the discount is taken in 40 percent of transactions, the expected value will be calculated as follows:

\[ ($100 \times 60\%) + ($90 \times 40\%) = $96 \]

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), 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 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, X 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:

\[ ($100 \times 30\%) + ($90 \times 70\%) = $93 \]
6.3.5.5.4 Accounting for “Trail Commissions”

Another form of variable consideration is trail commissions. For example, in many arrangements between an insurance agent and an insurance carrier, the insurance agent is entitled to additional consideration in the form of trail commissions each time a consumer renews an insurance policy with the insurance carrier. Although the insurance agent may satisfy its performance obligation when it sells an initial policy to a consumer (because it is not the insurance carrier), the ultimate consideration to which the insurance agent is entitled depends on how many times the consumer renews the policy with the insurance carrier (renewals do not require additional performance by the insurance agent). Example 6-10 below illustrates how an insurance agent would account for additional annual commissions earned for future expected policy renewals.

Example 6-10

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 receiving an initial commission from IC for every consumer IA signs up for IC’s insurance at the time of purchase (e.g., a $100 initial commission), IA receives annual commissions from IC 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.

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.

6.3.6 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 6-11**

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 for an amount up to $600, 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 (or the entity’s estimate of variable consideration has changed, subject to an assessment of the constraint) 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 7.6.

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3 An entity would allocate variable consideration and subsequent changes to it “entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation” if the criteria in ASC 606-10-32-40 are met.
6.4 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.

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:

<table>
<thead>
<tr>
<th>Legacy U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 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.</td>
<td>• 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 6.4.2, the model includes factors to be considered in the evaluation of whether the financing component is significant.</td>
</tr>
<tr>
<td>• There is no requirement for entities to recognize interest on advance payments received from transactions with customers.</td>
<td>• 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 (see Section 6.4.1 below).</td>
</tr>
</tbody>
</table>
Chapter 6 — Step 3: Determine the Transaction Price

6.4.1 Practical Expedient Providing Relief From the Significant Financing Component Guidance

Under legacy 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 (approximately one year or less) and the receivable or payable arises from a customer in the normal course of business. Under 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 legacy 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.

#### 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.

### 6.4.2 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:

- The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- 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. Sections 6.4.2.1 through 6.4.2.4 below further discuss the considerations inherent in an assessment of the existence and significance of a financing component in a contract with a customer.

### 6.4.2.1 Unit of Account for Assessing the Significance of a Financing Component

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, in part:

> 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.
6.4.2.2 Assessing Whether a Significant Financing Component Exists When the Consideration to Be Received Is Equal to the 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 component exists.

Sometimes, 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). 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 above issue is addressed in Implementation Q&A 32 (compiled from previously issued TRG Agenda Papers 20, 25, 30, and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

6.4.2.3 Requirement to Discount Trade Receivables When the Significant Financing Component Is Implicit

Example 6-12 below illustrates when it may be necessary to discount trade receivables even though a significant financing component is not explicitly identified in the contract.

**Example 6-12**

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 an observable 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.

Further, on the basis of ASC 606-10-32-16(b), B believes that the arrangement contains a significant financing component 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 the customer would have to pay to obtain financing from other sources.

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.
Example 6-12 (continued)

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.

6.4.2.4 How to Evaluate a Material Right for the Existence of a Significant Financing Component

The determination of whether there is a significant financing component associated with the material right depends on the facts and circumstances. Entities are required 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. See Section 11.6 for an example of a material right that gives rise to a significant financing component.

The above issue is addressed in Implementation Q&A 35 (compiled from previously issued TRG Agenda Papers 18, 25, 32, and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

6.4.3 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 necessarily all aspects of 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.
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.

**Connecting the Dots — 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 more instances in which an advance payment is in return for something other than financing than instances 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 fewer 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. This understanding is consistent with discussions by TRG members as outlined in TRG Agenda Paper 34, which states, “TRG members discussed the factor in paragraph 606-10-32-17(c) [62(c)] relating to whether the difference in promised consideration and cash selling price is for a reason other than financing, noting that it might be more likely that an advance payment would meet that factor compared to payments in arrears.”
6.4.3.1 Difference Between Consideration and Cash Selling Price That Arises for Reasons Other Than Financing

A difference in timing between the transfer of goods or services and the payment of consideration does not create a presumption that a significant financing component exists, even if there is a difference between the consideration and the cash selling price. 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 above issue is addressed in Implementation Q&A 31 (compiled from previously issued TRG Agenda Papers 20, 25, 30, and 34). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

6.4.3.1.1 SEC Staff Observations Regarding Significant Financing Components

In a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments, Sarah Esquivel, associate chief accountant in the SEC's Office of the Chief Accountant (OCA), made the following observations about an SEC registrant's consultation with the OCA on evaluating the existence of a significant financing component, in which the registrant concluded that there was no significant financing component in the arrangement:

In this consultation, the registrant was a retailer looking to expand a non-core existing line of business. To achieve this, the registrant entered into an arrangement with a third party to operate the non-core existing line of business, so that the registrant could maintain focus on its core operations. The registrant determined that the arrangement contained a symbolic license of intellectual property (IP), requiring revenue to be recognized over time, as the arrangement provided the third party with the right to access the registrant's trademarks and brand. As part of the consideration exchanged in the transaction, the registrant received a large up-front payment. As a result of the timing difference between the up-front payment and the transfer of the symbolic IP license over time, the registrant considered whether there was a significant financing component in the contract.

The registrant's analysis focused on consideration of the guidance in Topic 606 that indicates a contract would not have a significant financing component if the difference between the promised consideration and the cash selling price arises for reasons other than the provision of finance, and the difference between those amounts is proportional to the reason for the difference. In this consultation, the registrant asserted that it did not contemplate a financing arrangement with the third party when including a large up-front payment in the contract. Instead, the large up-front payment was to provide the registrant protection from the possibility that the third party could fail to adequately complete some or all of its obligations under the contract. The registrant concluded that the difference between the promised consideration and the cash selling price arose for reasons other than financing and that the difference between the up-front payment and what the customer would have paid, had the payments been made over the term of the arrangement, was proportional to the reason identified for the difference. In reaching this conclusion, the registrant considered the following:

- A large up-front payment was critical in this arrangement to incentivize the third party to maximize value, and therefore profits to both parties, due in part to the registrant's negative experience with other third parties where there was no up-front payment;
- By the third party having sufficient “skin in the game” through the large up-front payment, it would mitigate some of the risk associated with third-party use of the registrant's brand;


- As evidenced by its strong operating results, the registrant believed that it would be able to obtain financing at favorable rates in the market place, if needed, and thus did not need the cash from the large up-front payment to finance its operations; and
- Consideration was not given to structuring the transaction without a large up-front payment.

For these reasons, the registrant concluded that the contract did not have a significant financing component as the up-front payment was for reasons other than to provide a significant financing benefit. Like other Topic 606 revenue consultations that OCA has evaluated, this was a facts and circumstances evaluation, and in this fact pattern, the staff did not object to the registrant’s conclusion that the contract did not have a significant financing component based on the nature of the transaction and purpose of the up-front payment. [Footnotes omitted]

### 6.4.3.1.2 Codification Examples

The Codification examples below illustrate situations in which withheld payments or an advance payment would not indicate the existence of a significant financing component.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
<th>Example 27 — Withheld Payments on a Long-Term Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-233</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>55-234</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Example 30 — Advance Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-244</strong></td>
</tr>
<tr>
<td><strong>55-245</strong></td>
</tr>
<tr>
<td><strong>55-246</strong></td>
</tr>
</tbody>
</table>
6.4.3.2 Accounting for Financing Components That Are Not Significant

When an entity concludes on the basis of ASC 606-10-32-16 and 32-17 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. However, while there is no requirement for an entity to adjust for the time value of money when a financing component exists but is not significant, an entity is not precluded from doing so in such circumstances.

The above issue is addressed in Implementation Q&A 33 (compiled from previously issued TRG Agenda Papers 30 and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

6.4.4 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 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 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 and Subtopic 835-30 on the imputation of interest.

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

**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 on receivables and Subtopic 835-30 on the imputation of interest.

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

**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 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.

55-243 The following journal entries illustrate how the entity would account for the significant financing component.

- Recognize a contract liability for the $4,000 payment received at contract inception.
  
<table>
<thead>
<tr>
<th>Cash</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,000</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

- 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.

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>$494</td>
<td>$494</td>
</tr>
</tbody>
</table>

  \( ^{(a)} \) \( 494 = 4,000 \text{ contract liability} \times (6 \text{ percent interest per year for 2 years}) \)

- Recognize revenue for the transfer of the asset.

<table>
<thead>
<tr>
<th>Contract liability</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,494</td>
<td>$4,494</td>
</tr>
</tbody>
</table>

6.4.4.1 Determining the Appropriate Discount Rate on an Individual Contract Basis

If an entity gives its customers a significant benefit of financing, it should adjust the transaction price and corresponding amount of revenue recognized for the sale to take into account the effects of the time value of money. If the entity does not intend to apply a portfolio approach in determining the effects of this financing benefit, it should use the discount rate that would be reflected in a separate financing transaction between itself and its customer at contract inception in accordance with ASC 606-10-32-19. The way in which the entity identifies this rate will depend on the type of information to which it has access for individual customers.
In determining an appropriate discount rate, an entity may find it useful to consider the following:

- The normal rate at which the entity would provide secured or unsecured lending (whichever is appropriate) to its customer (e.g., any interest rate that would be normal for the entity to offer the customer).
- The normal rate at which other entities would provide secured or unsecured lending (whichever is appropriate) to the 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 the good or service 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 the entity obtains as a result of its due diligence processes (e.g., obtaining credit ratings).
- Historical evidence of any defaults or slow payment by the 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.

6.4.4.2 Determining the Appropriate Discount Rate Under a Portfolio Approach

In accordance with ASC 606-10-32-15, if an entity determines that the contract terms give customers a significant benefit of financing the purchase of the entity’s products, the entity should adjust the transaction price and corresponding amount of revenue recognized for the sale of the goods to take into account the effects of the time value of money.

Further, if the entity has a large number of similar contracts with similar payment terms and 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, it may apply a portfolio approach in accordance with ASC 606-10-10-4. See Section 3.1.2.2.1 for guidance on how to decide whether an entity may use a portfolio approach when applying ASC 606.

In applying a portfolio approach, the entity 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. Rather, it may be necessary for the entity to further subdivide the customer group when determining the appropriate discount rate.

6.4.5 Measuring the Amount of Revenue When a Transaction Includes a Significant Financing Component Related to Deferred Payments

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.

Example 6-13 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 6-13

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.

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Receivable as of January 1</th>
<th>Interest Income</th>
<th>Payment Received</th>
<th>Receivable as of December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$75,816</td>
<td>$7,581</td>
<td>$20,000</td>
<td>$63,397</td>
</tr>
<tr>
<td>20X2</td>
<td>63,397</td>
<td>6,340</td>
<td>20,000</td>
<td>49,737</td>
</tr>
<tr>
<td>20X3</td>
<td>49,737</td>
<td>4,974</td>
<td>20,000</td>
<td>34,711</td>
</tr>
<tr>
<td>20X4</td>
<td>34,711</td>
<td>3,471</td>
<td>20,000</td>
<td>18,182</td>
</tr>
<tr>
<td>20X5</td>
<td>18,182</td>
<td>1,818</td>
<td>20,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$24,184</td>
<td></td>
<td></td>
<td>$100,000</td>
</tr>
</tbody>
</table>

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
Example 6-13 (continued)

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 (or ASC 326-20, once adopted*).

**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.

**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.

<table>
<thead>
<tr>
<th>Receivable as of January 1</th>
<th>Interest Income</th>
<th>Payment Received</th>
<th>Receivable as of December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B = (A × 9.905%)</td>
<td>C</td>
<td>A + B – C</td>
</tr>
<tr>
<td>20X1 $76,000</td>
<td>$7,528</td>
<td>$20,000</td>
<td>$63,528</td>
</tr>
<tr>
<td>20X2 63,528</td>
<td>6,292</td>
<td>20,000</td>
<td>49,820</td>
</tr>
<tr>
<td>20X3 49,820</td>
<td>4,935</td>
<td>20,000</td>
<td>34,755</td>
</tr>
<tr>
<td>20X4 34,755</td>
<td>3,443</td>
<td>20,000</td>
<td>18,198</td>
</tr>
<tr>
<td>20X5 18,198</td>
<td>1,802</td>
<td>20,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$24,000</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

**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

* See ASC 326-10-65-1 through 65-4 for effective date and transition guidance related to ASC 326.
Example 6-13 (continued)

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 (or ASC 326-20, once adopted).

6.4.6 Measuring the Amount of Revenue When a Transaction Includes a Significant Financing Component Related to an Advance Payment

Example 6-14 below illustrates how an entity should account for an advance payment that represents a significant financing component.

Example 6-14

Entity A, a home builder, 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 (i.e., at a point in time), 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 in which A expects to complete construction and satisfy its performance obligation. Entity A capitalizes into inventory the interest in accordance with ASC 835-20 (i.e., interest expense is not recognized). When control of the apartment transfers to the customer, A recognizes $500,000 as revenue (and recognizes the related inventory balance as cost of goods sold). Essentially, the transaction price is increased by the amount of interest recognized over the 18-month period. As a result, revenue is recognized in an amount greater than the amount of initial cash collected.

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

See footnote 4.
Example 6-14 (continued)

Step 3

**Journal Entry: On transfer of control of the asset**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract liability</td>
<td>500,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>500,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>XXX</td>
</tr>
<tr>
<td>Inventories*</td>
<td>XXX</td>
</tr>
</tbody>
</table>

* As control of the asset is transferred, A will recognize the related inventory balance as cost of goods sold, including the $75,000 of interest that was capitalized into inventory in accordance with ASC 835-20.

6.4.7 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.
Chapter 6 — Step 3: Determine the Transaction Price

ASC 606-10 (continued)

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.

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
   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
   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.
**ASC 606-10 (continued)**

### Pending Content (Transition Guidance: ASC 326-10-65-1)

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset for right to recover product to be returned</td>
<td>$80(a)</td>
</tr>
<tr>
<td>Inventory</td>
<td>$80</td>
</tr>
</tbody>
</table>

(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):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable</td>
<td>$100(b)</td>
</tr>
<tr>
<td>Revenue</td>
<td>$100</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$80</td>
</tr>
<tr>
<td>Asset for product to be returned</td>
<td>$80</td>
</tr>
</tbody>
</table>

(b) 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.

### 6.4.8 Reassessment of Significant Financing Component

ASC 606-10-32-19 (reproduced in Section 6.4.4) states, in part, 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 6.3.6). 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.

**Connecting the Dots — 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 may 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.

### 6.5 Noncash Consideration

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>32-21</strong> 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).</td>
</tr>
<tr>
<td><strong>32-22</strong> 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.</td>
</tr>
<tr>
<td><strong>32-23</strong> 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.</td>
</tr>
<tr>
<td><strong>32-24</strong> 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.</td>
</tr>
</tbody>
</table>

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 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.

Changing Lanes — Noncash Consideration

The measurement date for noncash consideration is different under the new revenue standard. For example, legacy guidance generally requires an entity receiving customer equity instruments in lieu of cash consideration for goods or services provided to measure the fair value of the equity instruments when performance is complete (i.e., when the equity instruments vest). By comparison, ASC 606-10-32-21 requires an entity to measure the fair value of noncash consideration at contract inception.

In addition, the sequence of determining the fair value of noncash consideration is reversed under the new standard. Specifically, ASC 606-10-32-21 and 32-22 introduce the concept that requires an entity to first look to measure the estimated fair value of the noncash consideration and then consider the stand-alone selling price of the goods or services promised to the customer only when the entity is unable to reasonably estimate the fair value of the noncash consideration. In contrast, under legacy guidance in ASC 845, an entity is required to first consider the fair value of the goods or services surrendered and then look to the fair value of the asset acquired (i.e., the fair value of the noncash consideration) only if it is more evident than the fair value of the goods or services surrendered.

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6 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. See Appendix A for a summary of differences between U.S. GAAP and IFRS Standards on revenue-related topics.
The Codification example and Example 6-15 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.

**Example 6-15**

As part of Entity X’s revenue contract with Customer Y for the delivery of goods, X is entitled to receive 500 shares of Y’s common stock when all of the goods are provided to Y. In addition, if X delivers all goods within 90 days, it will receive an additional 100 shares of Y’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 X will receive may vary if 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 (in this example, 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).
Example 6-15 (continued)

For illustrative purposes, assume the following:
- At contract inception, the fair value of the 500 shares of Y’s common stock is $10 per share.
- Entity X determines that the probability of delivering all goods within 90 days is 15 percent and that the most likely amount method better predicts the amount of variable consideration to which it will be entitled.

Entity X determines at contract inception that the transaction price is $5,000 (500 shares × $10 per share) and recognizes revenue as the goods are provided.

After 60 days, X determines that there is a 90 percent probability that all goods will be delivered within the remaining 30 days of the contract. After 60 days, the fair value of Y’s common stock is $12 per share. On the basis of the fair value of Y’s common stock at contract inception, X now determines that the transaction price is $6,000 (600 shares × $10 per share). The change in the transaction price is due to a change in the estimate of variable consideration under the most likely amount method. That is, the variability in the transaction price results from “reasons other than the form of the consideration.” The change in the transaction price ignores any change in the fair value of Y’s common stock (the form of the consideration) since contract inception. Accordingly, in this example, the $2 increase in the fair value of the common stock would be accounted for under other applicable GAAP.

Connecting the Dots — Embedded Derivatives in Noncash Consideration

Example 6-15 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, variability in item (2) would be subsequently reassessed and remeasured, but variability 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.

6.5.1 Noncash Consideration in the Form of Internet Advertisement Space in the Advertisement Technology Industry

Noncash consideration may sometimes be used in the advertisement technology industry — specifically, an entity may be paid in the form of Internet advertising space (commonly referred to as “impressions”). In addition, the total number of impressions received by the entity may vary depending on the number of impressions generated by the customer. In such situations, the noncash consideration would also represent a form of variable consideration.

Unlike some other forms of noncash consideration, impressions generated in the advertisement technology industry do not represent assets that are transferred to the entity at contract inception. Rather, the impressions will be generated in the future and therefore will become assets of the entity when the impressions are generated and control of the impressions is transferred to the entity. Consequently, the entity does not have control of the impressions at contract inception.

7 Quoted from ASU 2016-12.
The entity should not recognize the fair value of the impressions promised by the customer until control of the impressions is transferred to the entity. This determination is consistent with the guidance in ASC 606-10-32-24, which requires an entity to account for contributed goods or services as noncash consideration if the entity obtains control of those contributed goods or services. Although ASC 606-10-32-24 focuses on the evaluation of whether an entity should account for goods or services contributed by a customer as noncash consideration received from the customer, it also helps an entity understand when noncash consideration should be recognized. That is, the guidance in ASC 606-10-32-24 indicates that noncash consideration should be recognized only when control of the consideration is transferred to the entity.

6.5.2 Accounting for Barter Credits

Example 6-16 below illustrates how an entity would account for radio and television advertising barter credits.

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**Example 6-16**

Company C, a retailer, enters into a transaction in which it transfers consumer product inventory to a barter company in exchange for radio and television advertising airtime barter credits. The radio and television advertising airtime is provided to the barter company by Company A, a broadcasting company. The airtime is available at certain times in certain markets for the next 24 months through a New York media outlet.

In the manner described in Section 3.2.5, C should first consider whether the barter credit transaction is subject to the scope exception for nonmonetary exchanges in ASC 606-10-15-2(e).

In accordance with ASC 606-10-15-2(e), nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers are outside the scope of ASC 606 and may be subject to the guidance in ASC 845 on nonmonetary transactions. Typically, no revenue is recognized when the guidance in ASC 845 is applied to such nonmonetary exchanges outside the scope of ASC 606.

As described above, C is a retailer and is not in the same line of business as the barter company or A, a broadcasting company. Therefore, the barter credit transaction is not subject to the scope exception in ASC 606-10-15-2(e). That is, the barter credit transaction is not a nonmonetary exchange that facilitates a sale to another party. Accordingly, C should consider whether the nonmonetary exchange represents a contract with a customer. Company C’s conclusion will depend on the facts and circumstances of the specific arrangement, including the terms of the parties’ contract.

If C concludes that the nonmonetary exchange represents a contract with a customer, C should account for the consideration it receives from the customer (i.e., radio and television advertising airtime barter credits) in exchange for the goods it provides to the customer (i.e., consumer product inventory) as noncash consideration. Under ASC 606-10-32-21, an entity is required to measure the estimated fair value of noncash consideration at contract inception when determining the amount of noncash consideration to include in the transaction price. Therefore, C should determine at contract inception the estimated fair value of the radio and television advertising airtime barter credits it receives from the customer. Since C does not receive any other consideration in the barter credit transaction, the estimated fair value of the radio and television advertising airtime barter credits at contract inception represents the transaction price of C’s contract to provide the consumer product inventory to the customer.

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8 A customer is 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.”
Connecting the Dots — 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 it 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.

6.6 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 without consideration of the amounts it paid to the customer. As a result, legacy 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.

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

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). Consideration payable to a customer also includes equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments). 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.

**Pending Content (Transition Guidance: ASC 718-10-65-15)**

32-25 Consideration payable to a customer includes:

- a. 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)
- b. 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)
- c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

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.
ASC 606-10 (continued)

32-25A Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payment awards). Changes in the measurement of the equity instrument (through the application of Topic 718) after the grant date that are due to the form of the consideration shall not be included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor’s income statement. See paragraphs 606-10-55-88A through 55-88B for implementation guidance on equity instruments granted as consideration payable to a customer.

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.

Changing Lanes — ASU 2018-07 on Nonemployee Share-Based Payment Accounting and ASU 2019-08 on Share-Based Consideration Payable to a Customer

In June 2018, the FASB issued ASU 2018-07 to improve the accounting for nonemployee share-based payments. The ASU supersedes the guidance in ASC 505-50 on equity instruments granted in conjunction with selling goods or services (i.e., sales incentives), under which such equity instruments have been accounted for in the same manner as cash consideration payable to a customer. Because the ASU supersedes this guidance, it also amends ASC 606-10-32-25 by expanding the scope of the guidance in that paragraph on consideration payable to a customer to include equity instruments granted in conjunction with the sale of goods or services. In addition, ASC 718-10-15-5A (added by ASU 2018-07) provides that “[i]f 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 as described in paragraph 606-10-32-26.” Accordingly, if share-based payments are granted to a customer as payment for a distinct good or service from the customer, an entity should apply the guidance in ASC 718 as amended by ASU 2018-07.

ASU 2018-07 is effective for public business entities (PBEs) for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other entities, ASU 2018-07 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than an entity’s date of adoption of ASC 606.
Chapter 6 — Step 3: Determine the Transaction Price

Note that while ASC 606 addresses how to recognize equity instruments granted as consideration payable to a customer, it does not provide guidance on the measurement of such equity instruments (including the measurement date). Therefore, in November 2019, the FASB issued ASU 2019-08 on share-based consideration payable to a customer, which clarifies the accounting for share-based payments issued as consideration payable to a customer in accordance with ASC 606 (i.e., share-based consideration payable to a customer that is not in exchange for distinct goods or services). ASU 2019-08 requires that entities measure and classify share-based sales incentives by applying the guidance in ASC 718. Accordingly, under the ASU, entities should measure share-based sales incentives by using a fair-value-based measure on the grant date, which would be the date on which the grantor (the entity) and the grantee (the customer) reach a mutual understanding of the key terms and conditions of the share-based sales incentive. The resulting measurement of the share-based sales incentive should be reflected as a reduction of revenue in accordance with the guidance in ASC 606 on consideration payable to a customer. After initial recognition, the measurement and classification of the share-based sales incentive continues to be subject to ASC 718 unless (1) the award is subsequently modified when vested and (2) the grantee is no longer a customer. The amendments in the ASU apply to share-based sales incentives issued to customers under ASC 606 that are not in exchange for distinct goods or services.

ASU 2019-08 requires an entity to apply the same transition provisions as those in ASU 2018-07. If an entity adopts ASU 2019-08 in the same fiscal year that it adopted ASU 2018-07, it should apply ASU 2019-08's provisions retrospectively for all relevant prior periods, beginning with its initial ASU 2018-07 adoption date. It should also make a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which it adopted ASU 2018-07.

If an entity adopts ASU 2019-08 in a fiscal year after the fiscal year that it adopted ASU 2018-07, it should elect to apply ASU 2019-08's provisions in one of the following ways:

- Retrospectively for all relevant prior periods beginning with its initial ASU 2018-07 adoption date, with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which it adopted ASU 2018-07 (i.e., use the same transition method as that used by entities that adopt it in the same fiscal year as their adoption of ASU 2018-07).

- On a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which it adopts ASU 2019-08.

ASU 2019-08 is effective for PBEs for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other entities that have early adopted ASU 2018-07, the amendments in ASU 2019-08 are effective for fiscal years beginning after December 15, 2019, including interim periods therein (the same adoption date as that for PBEs). For all other entities that have not early adopted ASU 2018-07, the amendments in ASU 2019-08 are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020 (the same adoption date as that in ASU 2018-07).

Early adoption is permitted for all entities (including in an interim period), but adoption may not be earlier than the date on which an entity adopts ASU 2018-07.

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 consideration payable to its customer:
6.6.1 Scope of the Guidance on Consideration Payable to a Customer

6.6.1.1 Identifying Customers Within the Scope of the Requirements Related to Consideration Payable to a Customer

As noted above, 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).

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. In addition, 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 should treat the consideration payable to the end customer as 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.
An agent’s agreement with the principal to provide consideration to the end customer may not have to be explicit. That is, contractual linkage is not necessarily required for the incentive payment to be treated as consideration payable to a customer. Depending on the facts and circumstances, an incentive payment could be implicitly agreed to (i.e., the principal may have a reasonable expectation that the incentive payment will be provided to its customers) and could represent consideration payable to a customer. Significant judgment may be required to determine whether an implicit agreement to provide an incentive to the principal’s customer results in consideration payable to a customer.

6.6.1.2 Identifying Payments Within the Scope of the Requirements Related to Consideration Payable to a Customer

In accordance with ASC 606-10-32-25, as amended by ASU 2018-07 and ASU 2019-08, consideration payable to a customer includes the following:

a. 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)

b. 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)

c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

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).

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.

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).
Example 6-17

Natural Gas Inc. (the “Company”) is a supplier of renewable natural gas for commercial vehicle operators, which are the Company's customers. To increase its sales of renewable natural gas, the Company offers an incentive to its customers to use natural gas–powered vehicles (rather than diesel-powered vehicles). To offer the incentive to its customers, the Company partners with Car Rental Inc., an unrelated third-party commercial vehicle lessor.

The Company’s incentive program for its customers is structured as follows:

- The customer enters into a three-year lease agreement for a natural gas–powered vehicle with Car Rental Inc. The terms of the lease agreement stipulate that the customer is to make lease payments to Car Rental Inc. that are equal to the market rate for a leased diesel-powered vehicle, which is less than the market rate for the leased natural gas–powered vehicle. At the direction of the customer, the Company makes cash payments directly to Car Rental Inc. to cover the difference between the market rate for a leased diesel-powered vehicle and the market rate for the leased natural gas–powered vehicle.

- If the customer leases a natural gas–powered vehicle, the customer executes a separate natural gas supply contract with the Company in exchange for the Company’s cash payments to Car Rental Inc. that commits the customer to purchase a minimum volume of natural gas from the Company. The Company’s incremental cash payments to Car Rental Inc. are required on the basis of the Company’s contract with the customer. The Company’s customer billings for the natural gas have sufficient margins to cover the Company’s incremental cash payments to Car Rental Inc.

- The Company is named as a secondary lienholder of the leased natural gas–powered vehicle (subordinate to Car Rental Inc.). However, the Company does not take possession of the leased asset (the natural gas–powered vehicle) at any time, does not operate the natural gas–powered vehicle at any time, and does not control the natural gas–powered vehicle with respect to its use. In the event that the customer defaults under its lease agreement with Car Rental Inc., the Company is not obligated to make lease payments for the natural gas–powered vehicle.

The Company’s cash payments to Car Rental Inc. should be accounted for as consideration payable to a customer in accordance with ASC 606-10-32-25 through 32-27 even though Car Rental Inc. is not the Company’s customer, the customer’s customer, or another party in the distribution channel for the Company’s natural gas.

As stated in Section 6.6.1.1, the requirements related to consideration payable to a customer should be applied more broadly to include parties outside the distribution chain depending on the facts and circumstances. While the Company’s cash payments are not to its customer’s customer, the cash payments to Car Rental Inc. are required on the basis of the Company’s contract with the customer. Accordingly, the Company should account for the cash payments to Car Rental Inc. as consideration payable to a customer. Since the Company could have made the cash payments directly to the customer, which then could have paid Car Rental Inc. for the lease payments in their entirety, we believe that there is no difference in the substance of the arrangement.

Further, the Company does not receive a distinct good or service in exchange for the cash payments to Car Rental Inc. Therefore, in accordance with ASC 606-10-32-25 through 32-27, the consideration payable to the customer should be recognized as a reduction of the transaction price when or as the related goods or services are transferred to the customer.

The above issue is addressed in Implementation Q&A 25 (compiled from previously issued TRG Agenda Papers 19, 25, 28, 34, 37, and 44). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.
6.6.1.3 Accounting for an Entity's Participation in Its Customer's Third-Party Financing

In certain revenue transactions, an entity may participate in a customer's third-party financing by (1) providing financial guarantees or indemnifications to the financing party or (2) buying down interest rate points payable to the financing party to give the customer a sales incentive. These types of arrangements may be structured in any of various forms, such as one in which the customer obtains third-party financing to do either of the following:

- Pay for a product up front when the product is delivered.
- Make payments to the entity over time rather than pay any up-front consideration to the entity.

Depending on the facts and circumstances of the particular arrangement, an entity's participation in its customer's third-party financing may (1) affect the entity's assessment that collectibility of substantially all of the consideration to which the entity will be entitled for goods or services transferred to the customer is probable, (2) affect the entity's determination of the transaction price of the entity's contract with the customer, or (3) result in a guarantee within the scope of ASC 460.

When an entity's customer has obtained third-party financing and the entity participates in the financing, the entity should first evaluate whether its participation in the financing results in a guarantee within the scope of ASC 460.

If the entity's participation in the financing is not a guarantee within the scope of ASC 460, the entity should still consider whether the nature of the arrangement may affect the assessment of collectibility or increase the probability that the entity will offer a price concession to the customer. That is, through the entity's participation in the third-party financing, the entity may inherently be more likely to accept an amount that is less than what it is entitled to under the contract. Specifically, under the revenue recognition framework of ASC 606, the entity will need to evaluate whether (1) its participation in the financing affects its assessment that collectibility of substantially all of the consideration to which the entity will be entitled for goods or services transferred to the customer is probable (step 1) or (2) any potential price concessions represent variable consideration that should be included in the determination of the transaction price (step 3). See Sections 4.3.5 through 4.3.5.5 for further discussion of collectibility concepts, including those related to price concessions.

In addition, under the revenue recognition framework of ASC 606, the entity should consider whether the nature of the arrangement includes consideration payable to a customer that would be accounted for as a reduction in the transaction price (step 3). If the payments made by the entity to the financing party are contractually or economically linked to the entity's revenue contract with the customer, the entity should account for those payments as consideration payable to a customer.
6.6.2 Applying the Guidance on Consideration Payable to a Customer

The following example in ASC 606 illustrates how an entity would account for consideration payable to a customer:

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### 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).

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6.6.2.1 Meaning of “Distinct” Goods or Services

In accordance with ASC 606-10-32-25, 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.”

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 entity’s revenue contract with the customer (i.e., the customer’s promise to transfer the good or service to the entity is distinct within the context of the contract, and the benefit to be received by the entity is separable from the sale of goods or services 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 Section 6.6.2.3).

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 6-18

**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 and its own sales of goods to Y are highly interrelated. 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 Section 6.6.2.3).

### Example 6-19

**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 and its own sales of goods to F are highly interrelated; 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 Section 6.6.2.3).
Example 6-20

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.

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, if the fair value can be reasonably estimated, 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.

Connecting the Dots — Slotting and Listing Fees

In the retail industry, it is common for a wholesaler to pay a retailer (the wholesaler’s 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 that guidance, stakeholders have asked whether the wholesaler in an arrangement involving slotting or listing fees receives a distinct good or service from the retailer in return for the payment of these 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 generally 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.

6.6.2.2 Consideration Payable to a Customer and Variable Consideration

In a manner similar to that under legacy U.S. GAAP, the new revenue standard requires an entity to recognize consideration payable to a customer as a reduction of revenue at the later of when the entity (1) recognizes revenue for the transfer of the related goods or services or (2) pays or promises to pay such consideration. However, under the new revenue standard, an entity also has to take into account variable consideration when determining the transaction price.

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9 An entity’s promise to pay, or payment of, consideration to a customer may be dependent on a future event, implied by the entity’s customary business practices, or both. This concept is discussed in the “later of” guidance in ASC 606-10-32-27 on consideration payable to a customer.
For example, if an entity anticipates that it may provide a coupon to the customer when entering into
the contract, or if, given the facts and circumstances, an entity can conclude that the customer has a
valid expectation that it will receive a price concession in the form of a coupon, the coupon represents
variable consideration that the entity should estimate at contract inception.\textsuperscript{10} The entity's anticipation
or the customer's expectation of a price concession does not need to be explicit and instead may be
determined on the basis of the entity's history of granting price reductions through coupons (i.e., on
the basis of the entity's customary business practices even though the coupon is not explicitly stated in
the contract). Accordingly, the entity should apply the guidance on estimating variable consideration in
ASC 606-10-32-5 and should reduce the transaction price before the payment is communicated to the
customer (i.e., at contract inception, when the transaction price is estimated).

Because an entity needs to take into account the variable consideration guidance in determining when
to recognize price concessions such as coupons provided to a customer, it is expected that the "later of"
guidance in ASC 606-10-32-27 on consideration payable to a customer under the new revenue standard
will be applied in more limited circumstances than similar guidance was under legacy U.S. GAAP.
Consequently, there may be a change in practice for some entities.

The above issue is addressed in Implementation Q&A 29 (compiled from previously issued TRG Agenda
Papers 19, 25, 28, 34, 37, and 44). For additional information and Deloitte's summary of issues discussed
in the Implementation Q&As, see Appendix C.

\textbf{6.6.2.3 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 such a way 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 such a way 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. When the
fair value of the goods or services can be reasonably estimated, the accounting outcome should be the
same in either circumstance.

The goods or services supplied by the customer should be accounted for separately if both of the
following conditions are met:

\begin{itemize}
  \item Those goods or services are “distinct” (see Section 6.6.2.1).
  \item 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).
\end{itemize}

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.

\textsuperscript{10} While this section discusses coupons, price concessions that an entity intends to provide may be in other forms, such as cash payments, rebates,
and account credits. These would also be regarded as forms of variable consideration.
The examples below illustrate the application of this guidance.

**Example 6-21**

An entity sells goods to a customer for $10,000 and, as part of the same arrangement, pays that customer $1,000 in exchange for 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 6-22**

An entity sells goods to a customer for $10,000 and, as part of the same arrangement, pays that customer $1,000 in exchange for 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. If the contract is net settled (i.e., the customer is required to pay cash and provide distinct goods or services as payment for the goods or services provided by the entity to the customer, and the entity does not make a cash payment to the customer for the distinct goods or services provided by the customer), the noncash consideration guidance would apply (see Section 6.5).

**6.6.2.4 Impact of Negative Revenue on Presentation of Consideration Payable to a Customer**

In certain arrangements, amounts paid (or payable) to a customer could exceed the consideration to which the entity expects to be entitled from the customer. In these situations, recognition of payments to the customer as a reduction of revenue could result in “negative revenue.” Legacy revenue guidance in ASC 605-50 includes explicit guidance on how to account for payments to customers that result in negative revenue. In these cases, ASC 605-50-45-9 requires an entity to reclassify the cumulative shortfall (i.e., the amount of the payment to a customer in excess of the entity’s cumulative revenue from the customer) from a reduction of revenue to an expense unless certain conditions exist.

Unlike the legacy guidance in ASC 605-50, ASC 606 does not specifically address situations in which the entity could potentially recognize negative revenue if it accounts for consideration payable to a customer as a reduction of revenue.

The absence of explicit guidance in ASC 606 was acknowledged in TRG Agenda Paper 19, which was prepared by the FASB and IASB staffs for the TRG’s January 2015 meeting. Specifically, those staffs acknowledged in paragraph 27 of TRG Agenda Paper 19 that ASC 606 “does not currently address the accounting for ‘negative revenue.’” Although negative revenue was included as an issue for discussion in TRG Agenda Paper 19, the TRG did not reach a consensus on whether and, if so, when negative revenue should be reclassified as an expense.
In the absence of explicit guidance in ASC 606, we believe it would be acceptable for entities to consider the legacy guidance in ASC 605-50 by analogy and reclassify negative revenue as an expense if certain conditions are met. Specifically, ASC 605-50-45-9 states:

A vendor may remit or be obligated to remit cash consideration at the inception of the overall relationship with a customer before the customer orders, commits to order, or purchases any vendor products or services. Under the guidance in the preceding two paragraphs, any resulting negative revenue may be recharacterized as an expense if, at the time the consideration is recognized in the income statement, it exceeds cumulative revenue from the customer. However, recharacterization as an expense would not be appropriate if a supply arrangement exists and either of the following circumstances also exists:

a. The arrangement provides the vendor with the right to be the provider of a certain type or class of products or services for a specified period of time and it is probable that the customer will order the vendor’s products or services.

b. The arrangement requires the customer to order a minimum amount of vendor products or services in the future, except to the extent that the consideration given exceeds probable future revenue from the customer under the arrangement.

Example 6-23

On January 1, 20X1, Company A enters into a master supply agreement with Customer X to sell X an undefined quantity of widgets over a five-year period. A sale of widgets is initiated each time X issues a purchase order to A, at which point A is legally obligated to supply X with the quantity of widgets specified in the purchase order. Company A expects that it is probable that X will purchase a total of 1,000 widgets per year (i.e., 5,000 widgets over the term of the master supply agreement). The price of each widget is $5.

As an incentive for X to enter into the master supply agreement, A agrees to pay X $30,000 upon receipt of the first purchase order. On January 15, 20X1, X issues its first purchase order to A for 200 widgets. Customer X pays A $1,000 for the 200 widgets and receives the $30,000 payment from A. Company A determines that at least some of the $30,000 payment meets the definition of an asset (see Section 6.6.3 for considerations related to whether an up-front payment meets the definition of an asset). In addition, A determines that the $30,000 is not in exchange for a distinct good or service.

To determine the amount of negative revenue, A compares the $30,000 payment to X with the total purchases that A believes it is probable that X will make over the term of the master supply agreement (i.e., $25,000 for 5,000 widgets). Because the consideration payable to X ($30,000) exceeds the total expected purchases from X ($25,000), it would be acceptable for A to reclassify the cumulative shortfall ($5,000) as an expense.

6.6.2.5 Applying the Guidance on Consideration Received From a Vendor

Under legacy U.S. GAAP, entities would account for consideration received from a vendor in accordance with ASC 605-50, which was codified on the basis of EITF Issue 02-16. ASC 605-50 is superseded by ASC 705-20, a Codification subtopic that ASU 2014-09 added to provide specific guidance on consideration received from a vendor.
Consideration from a vendor includes cash amounts that an entity receives or expects to receive from a vendor (or from other parties that sell the goods or services to the vendor). Consideration from a vendor also includes credit or other items (for example, a coupon or voucher) that the entity can apply against amounts owed to the vendor (or to other parties that sell the goods or services to the vendor). The entity shall account for consideration from a vendor as a reduction of the purchase price of the goods or services acquired from the vendor unless the consideration from the vendor is one of the following:

a. In exchange for a distinct good or service (as described in paragraphs 606-10-25-19 through 25-22) that the entity transfers to the vendor

b. A reimbursement of costs incurred by the entity to sell the vendor’s products

c. Consideration for sales incentives offered to customers by manufacturers.

If the consideration from a vendor is in exchange for a distinct good or service (see paragraphs 606-10-25-19 through 25-22) that an entity transfers to the vendor, then the entity shall account for the sale of the good or service in the same way that it accounts for other sales to customers in accordance with Topic 606 on revenue from contracts with customers. If the amount of consideration from the vendor exceeds the standalone selling price of the distinct good or service that the entity transfers to the vendor, then the entity shall account for such excess as a reduction of the purchase price of any goods or services acquired from the vendor. If the standalone selling price is not directly observable, the entity shall estimate it in accordance with paragraphs 606-10-32-33 through 32-35.

Cash consideration represents a reimbursement of costs incurred by the entity to sell the vendor’s products and shall be characterized as a reduction of that cost when recognized in the entity’s income statement if the cash consideration represents a reimbursement of a specific, incremental, identifiable cost incurred by the entity in selling the vendor’s products or services. If the amount of cash consideration paid by the vendor exceeds the cost being reimbursed, that excess amount shall be characterized in the entity’s income statement as a reduction of cost of sales when recognized in the entity’s income statement.

Manufacturers often sell their products to resellers who then sell those products to consumers or other end users. In some cases, manufacturers will offer sales discounts and incentives directly to consumers — for example, rebates or coupons — in order to stimulate consumer demand for their products. Because the reseller has direct contact with the consumer, the reseller may agree to accept, at the point of sale to the consumer, the manufacturer’s incentives that are tendered by the consumer (for example, honoring manufacturer’s coupons as a reduction to the price paid by consumers and then seeking reimbursement from the manufacturer). In other instances, the consumer purchases the product from the reseller but deals directly with the manufacturer related to the manufacturer’s incentive or discount (for example, a mail-in rebate).

The recognition guidance in ASC 705-20-25 on consideration received from a vendor has certain conceptual similarities to the measurement guidance in ASC 606-10-32 on consideration payable to a customer.

ASC 606-10-32-25 states that 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” (emphasis added). Under ASC 606-10-32-26, “[i]f 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” (emphasis added).
Similarly, under ASC 705-20-25-1 and 25-2, an entity will need to determine whether consideration from a vendor is **in exchange for a distinct good or service** (as described in ASC 606-10-25-19 through 25-22) that the entity transfers to the vendor. If an entity concludes that consideration received from a vendor is related to distinct goods or services provided to the vendor, the entity should account for the consideration received from the vendor **in the same way that it accounts for other sales** (e.g., in accordance with ASC 606 if distinct goods or services are sold to a customer). If the consideration is not in exchange for a distinct good or service and is also unrelated to the items described in ASC 705-20-25-1(b) and (c), the entity should account for consideration received from a vendor as a **reduction of the purchase price** of the goods or services acquired from the vendor. Also similar to the guidance in ASC 606-10-32-25 and 32-26 is the requirement in ASC 705-20-25-2 that any excess of the consideration received from the vendor over the stand-alone selling price of the good or service provided to the vendor should be accounted for as a reduction of the purchase price of any goods or services purchased from the vendor.\(^\text{11}\)

### Changing Lanes — Consideration Received From a Vendor

Under legacy U.S. GAAP (i.e., ASC 605-50), consideration received from a vendor could be accounted for as revenue (or other income, as appropriate) only if a separate benefit was provided to the vendor. For that condition to be met, the identified benefit provided would need to (1) be sufficiently separable from the customer’s purchase of the vendor’s products and (2) have a readily determinable fair value.

ASC 705-20 retains the “separate identified benefit” concept, although it provides, in a manner consistent with the ASC 606 framework, that for a customer to account for consideration received from a vendor as revenue, the consideration received must be in exchange for the transfer of a distinct good or service. However, ASC 705-20 does not require the distinct good or service to have a readily determinable fair value. Rather, ASC 705-20-25-2 states, in part, that “[i]f the standalone selling price is not directly observable, the entity shall estimate it in accordance with paragraphs 606-10-32-33 through 32-35.” By requiring a customer to estimate the stand-alone selling price of the distinct good or service provided to the vendor if that price is not directly observable, ASC 705-20-25-2 may change the accounting outcome for a customer that previously concluded under legacy U.S. GAAP that the benefit provided to the vendor does not have a readily determinable fair value.

The concepts in **Section 6.6.2.1** that address how to evaluate whether consideration payable to a customer is in exchange for distinct goods or services purchased from a customer are also applicable to the determination of whether consideration received from a vendor is in exchange for distinct goods or services delivered to a vendor.

Notwithstanding the similarities between ASC 705-20 and ASC 606, determining whether an entity is a customer or a vendor in certain arrangements may be challenging. As discussed in **Section 3.2.8**, there are certain arrangements in which an entity may enter into one or more contracts with another entity that is both a customer and a vendor. That is, the reporting entity may enter into one or more contracts with another entity to (1) sell goods or services that are an output of the reporting entity’s ordinary activities in exchange for consideration from the other entity and (2) purchase goods or services from the other entity. In these types of arrangements, the reporting entity will need to use judgment to determine whether the other entity is predominantly a customer or predominantly a vendor. This determination might not be able to be made solely on the basis of the contractual terms. In such cases,

\(^{11}\) If an entity concludes that the consideration received from a vendor was not in exchange for a distinct good or service that the entity transferred to the vendor, the entity will be required under ASC 705-20-25-1 to (1) determine whether the consideration received was either a reimbursement of costs incurred by the entity to sell the vendor’s products or consideration for sales incentives offered to customers by manufacturers and (2) account for the consideration received accordingly.
the reporting entity will need to consider the facts and circumstances of the overall arrangement with the other entity. Example 6-24 below illustrates an arrangement in which this issue may arise and discusses how the reporting entity may determine whether the other entity in the arrangement is predominantly a customer or predominantly a vendor. This distinction may be important to determining whether the reporting entity should apply the guidance on consideration payable to a customer in ASC 606 or the guidance on consideration received from a vendor in ASC 705-20.

**Example 6-24**

Entity B offers digital media analytics products and services that report on digital activity to identify trends and provide insights to customers. Entity B purchases data from third-party operators, which it analyzes, measures and combines with a wide variety of other data obtained from various sources for use in the products and services that it sells to its customers.

Entity B has entered into an agreement with Operator C, a telecommunications company, to purchase C’s data. Operator C’s data will be combined with data provided from other sources, analyzed, and used as an input for delivering data subscription services to B’s customers. Before negotiating the agreement to purchase C’s data, B entered into an agreement to provide data subscription services and several other services to C. Consequently, B has contracts with C to (1) purchase data from C in exchange for cash consideration and (2) sell various services to C in exchange for cash consideration.

Since C could be viewed as both a customer and a vendor of B, B evaluates whether C is predominantly a customer or predominantly a vendor in their arrangement. Entity B’s conclusion may determine whether (1) the consideration paid to C for C’s data should be analyzed under ASC 606 (i.e., potentially as a reduction of the transaction price for the data subscription services provided to C) or (2) the consideration received from C for the data subscription services should be analyzed under ASC 705-20 (i.e., potentially as a reduction of the purchase price of the data provided to B).

To determine whether C is predominantly a customer or predominantly a vendor in the arrangement, B considers qualitative and quantitative factors, including the following:

- The extent to which the data purchased from C are important to B’s ability to successfully sell its products and services to customers (e.g., whether C’s data represent a significant portion of all of the data analyzed and included in B’s products and services), or the extent to which the services purchased from B are important to C (e.g., whether C attributes significant value to the insights obtained from the data services provided by B).
- The quantitative significance of B’s past, current, and expected future (1) purchases of data from C and (2) sales of data subscription services to C.
- The extent to which B (1) sells other products and services to C and (2) purchases other products and services from C.
- The historical relationship between B and C, as applicable.
- The pricing of B’s products and services sold to C as compared with the pricing of products and services that B sells to other customers of similar size and nature.
- The pricing of C’s data purchased by B as compared with the pricing of similar data that B purchases from other vendors.
- The substance of the contract negotiation process or contractual terms between B and C, which may indicate that (1) B is the customer and C is the vendor or (2) C is the customer and B is the vendor.
- The payment terms and cash flows between B and C.
- The significance of other parties involved in the arrangement.

Regardless of whether B concludes that C is predominantly a customer or predominantly a vendor in the arrangement, B must evaluate whether its purchase of C’s data is distinct from the services sold to C in accordance with ASC 705-20 or ASC 606.
In addition, if the consideration paid to C is accounted for under ASC 606 and B has concluded that the consideration payable to C is a payment for a distinct good or service, B should account for the purchase of the data in the same way that it accounts for other purchases from suppliers. However, B must evaluate whether the consideration paid to C for the data represents the fair value of the data received. If the amount of consideration payable to C exceeds the fair value of the data that B receives from C, B should account for such an excess as a reduction of the transaction price. If B cannot reasonably estimate the fair value of the data received from C, it should account for all of the consideration payable to C as a reduction of the transaction price.

If the consideration received from C is instead accounted for under ASC 705-20 and B has concluded that the consideration from C is in exchange for a distinct good or service, B should account for the sale of the service in the same way that it accounts for other sales to customers in accordance with ASC 606. However, B must evaluate whether the services sold to C were sold at the stand-alone selling price. If the amount of consideration received from C exceeds the stand-alone selling price of the services that B transfers to C, B should account for the excess as a reduction of the purchase price of the data acquired from C.

6.6.3 Accounting for Up-Front Payments to Customers

In developing the new revenue standard, the FASB and IASB did not broadly reconsider the accounting for up-front payments made to customers. Under legacy revenue guidance, there was diversity in practice related to the accounting for up-front payments made to customers, with the ultimate accounting being highly dependent on the specific facts and circumstances underlying the payments. While the new revenue standard provides explicit guidance on accounting for payments made to customers, such guidance does not distinguish the accounting for payments made to customers at the inception of the contract (i.e., up-front payments) from the accounting for payments made to customers during the contract period.

The new revenue standard specifies that if consideration paid to a customer is not in exchange for a distinct good or service, the consideration paid should be reflected as a reduction of the transaction price that is allocated to the performance obligations in the contract. If an up-front payment is made as part of an enforceable contract with a customer (i.e., a contract that meets all of the criteria in ASC 606-10-25-1, as discussed in Section 4.3), treating that payment as a reduction of the transaction price would result in the recording of an asset for the up-front payment made, which would then be recognized as a reduction of revenue as the promised goods or services are transferred to the customer. The recording of an asset and subsequent amortization is predicated on the fact that the asset represents an advance of funds to the customer, which the entity recovers as goods or services are transferred to the customer.

However, the new revenue standard is less clear on the accounting for up-front payments when either (1) a revenue contract does not yet exist (i.e., an entity makes a payment to incentivize the customer to enter into a revenue contract with the entity) or (2) an up-front payment is related to goods or services to be transferred under a current contract and anticipated future contracts.
Connecting the Dots — Up-Front Payments to Customers

Implementation Q&A 43 (compiled from previously issued TRG Agenda Papers 59 and 60) discusses how an entity should account for an up-front payment made to a customer when (1) a revenue contract does not yet exist (i.e., an entity makes a payment to incentivize a customer to enter into a revenue contract with the entity) or (2) the up-front payment is related to goods or services to be transferred under a current contract and anticipated future contracts. That Q&A presents the following two views on when an up-front payment to a customer should be recognized as a reduction of revenue:

• **View A** — A payment to a customer should be recognized as an asset and amortized as a reduction of revenue as the entity provides the customer with the related goods or services (i.e., the expected total purchases resulting from the up-front payment). Under this approach, the up-front payment may be recognized as a reduction of revenue over a period that is longer than the currently enforceable contract term.

• **View B** — Payments to customers should be recognized as a reduction of revenue only over the current contract term. If a contract does not yet exist, the up-front payment should be recognized as a reduction of revenue immediately.

View A would often be appropriate; if an asset is recorded, it should be an asset as defined in FASB Concepts Statement 6. In addition, View B would sometimes be appropriate.

However, as stated in Implementation Q&A 43, the selection of either view is not an accounting policy election but should be made after entities “understand the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances for each arrangement when determining the appropriate accounting.” Further, while acknowledging that some diversity in practice may continue under the new revenue standard, the FASB staff emphasized that the standard’s requirement to provide increased disclosure about judgments made in the determination of the transaction price should help financial statement users understand an entity’s accounting for up-front payments to customers.

For additional information and Deloitte's summary of the Implementation Q&As, see Appendix C.

When determining how to account for an up-front payment to a customer that is not in exchange for a distinct good or service, an entity should first consider whether the up-front payment meets the definition of an asset. FASB Concepts Statement 6 defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

In a **speech** at the 2016 AICPA Conference on Current SEC and PCAOB Developments, Ruth Uejio, then professional accounting fellow in the OCA, provided the following guidance on determining whether an up-front payment constitutes an asset:

> From my perspective, a company must first determine what the payment was made for. The following are some of the questions that OCA staff may focus on to understand the nature and substance of the payment:

1. What are the underlying economic reasons for the transaction? Why is the payment being made?
2. How did the company communicate and describe the nature of the payment to its investors?
3. 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?
4. What is the accounting basis for recognizing an asset, or recognizing an upfront payment immediately through earnings?
Once a company has determined the substance of the payment, I believe 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. Additionally, companies should establish accounting policies that are consistently applied. I’d highlight that there should be a neutral starting point in the accounting evaluation for these types of arrangements. I believe that registrants must carefully evaluate all of the facts and circumstances in arriving at sound judgments, and should perform the analysis impartially. Additionally, in my view “matching” is not a determinative factor to support asset recognition.

To recognize an up-front payment to a customer as an asset, an entity needs to be assured that a probable future economic benefit is being obtained or controlled in exchange for providing the customer with the up-front payment. In evaluating whether an up-front payment to a customer meets the definition of an asset, an entity should consider the following:

- Whether the up-front payment is expected to be recovered through the customer’s purchases under the initial contract or an anticipated contract.
- The entity’s history of renewals with that specific customer or similar classes of customers.
- The negotiation process for the up-front payment and how the payment is characterized in the contract with the customer.

If the entity determines that the payment meets the definition of an asset, the payment should be recognized as an asset and subsequently “amortized” as a reduction of revenue as the related goods or services are provided to the customer over a period that may continue beyond the current contract term. If, on the other hand, the payment does not meet the definition of an asset, it may be more appropriate to recognize the payment as a reduction of revenue immediately. For example, we believe that for an asset to be recognized, the payment must be recoverable. In our view, it would be reasonable for an entity to assess recoverability by performing the same analysis it uses to evaluate the costs of obtaining or fulfilling a contract under ASC 340-40.

**Connecting the Dots — SEC Observer’s Comments on Up-Front Payments to Customers**

The SEC observer at the November 2016 TRG meeting noted that an entity will need to use judgment in assessing up-front payments to customers and emphasized that the entity must appropriately disclose its conclusions related to the up-front payments in both its financial statements and MD&A. In addition, the SEC observer noted that the SEC staff intends to form its views on the topic by analyzing the guidance in the new revenue standard independently of its past decisions that were based on the legacy guidance in ASC 605.

### 6.6.4 Warranty Payments Versus Variable Consideration

#### 6.6.4.1 Accounting for Liquidating Damage Obligations as Warranties or Variable Consideration

Some contracts (e.g., service level agreements) 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.

In general, cash refunds, liquidating damages, fines, penalties, or other similar features should be evaluated as variable consideration, as illustrated in Example 20 in ASC 606-10-55-194 through 55-196 (reproduced below). However, an entity must consider the specific facts and circumstances in reaching this conclusion.
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.

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 in 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 in-substance assurance- or service-type warranty.

Example 6-25

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.

6.6.4.2 Accounting for a Refund of the Purchase Price Following the 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.”

The guidance on accounting for warranties in ASC 606-10-55-30 through 55-35 should not be applied to an obligation to provide a full or partial refund of consideration received for defective products. 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.

6.7 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 legacy 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.

**Changing Lanes — Sales Taxes**

While the scope of sales taxes in the new revenue standard aligns with that in ASC 605-45-15-2(e) under legacy U.S. GAAP, the policy election is different. Under legacy guidance, an entity can elect to account for the taxes on either a gross basis or a net basis. However, Under ASC 606, if an entity does not elect to account for the taxes on a net basis, it must assess whether it is a principal (and should therefore present the taxes on a gross basis) or an agent (and should therefore present the taxes on a net basis) for all taxes (i.e., it cannot elect to present all taxes on a gross basis without further analysis).
Chapter 7 — Step 4: Allocate the Transaction Price to the Performance Obligations

7.1 Background
7.2 Stand-Alone Selling Price
7.3 Determine the Stand-Alone Selling Price
7.4 Allocation of a Discount
7.5 Allocation of Variable Consideration
7.6 Changes in the Transaction Price
7.7 Allocation Considerations for Significant Financing Components
7.1 Background

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 performance obligation. 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 or distinct good or service. 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.

7.2 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 stand-alone 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.
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:

<table>
<thead>
<tr>
<th>Product</th>
<th>Standalone Selling Price</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$50</td>
<td>Directly observable (see paragraph 606-10-32-32)</td>
</tr>
<tr>
<td>Product B</td>
<td>$25</td>
<td>Adjusted market assessment approach (see paragraph 606-10-32-34(a))</td>
</tr>
<tr>
<td>Product C</td>
<td>$75</td>
<td>Expected cost plus a margin approach (see paragraph 606-10-32-34(b))</td>
</tr>
<tr>
<td>Total</td>
<td>$150</td>
<td></td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Product</th>
<th>Standalone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$33 ($50 ÷ $150 × $100)</td>
</tr>
<tr>
<td>Product B</td>
<td>$17 ($25 ÷ $150 × $100)</td>
</tr>
<tr>
<td>Product C</td>
<td>$50 ($75 ÷ $150 × $100)</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
</tr>
</tbody>
</table>

7.3 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 a similar 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).

7.3.1 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 historically required under ASC 605-25. That is, an entity does not need to first conclude that it does not have vendor-specific objective evidence (VSOE) of selling price or third-party evidence of selling price for a performance obligation 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 selling price under ASC 605 when VSOE of selling price is supported by consistent pricing of stand-alone sales (see Section 7.3.3.1). In a manner similar to legacy practice, an entity will need to estimate the stand-alone selling price if an observable stand-alone selling price does not exist.

7.3.2 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.
Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

- **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.

- **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.

- **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).

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.

Stand-alone selling prices must be estimated if, and only if, they are not directly observable. Although ASC 606 does not prescribe a specific approach for estimating stand-alone selling prices that are not directly observable, an entity is required to use an 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. In addition, an entity should consider all information that is reasonably available in determining a stand-alone selling price.

**Changing Lanes — Residual Method Under Legacy 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 legacy guidance in ASC 985-605 (formerly SOP 97-2), 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 ASC 985-605 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. 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 legacy U.S. GAAP, if the selling price (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 legacy 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 legacy U.S. GAAP, the residual method should be used whenever there is VSOE of selling price 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 7.3.3, 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 selling price for undelivered PCS under legacy 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.
7.3.3 Examples of Determining the Stand-Alone Selling Price

7.3.3.1 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.

Because the actual amount paid for the PCS in the software arrangements described above 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, the contractually stated renewal rate may not necessarily represent the stand-alone selling price for the PCS, especially when PCS is renewed for a broad range of amounts.

If an entity determines that it does not have observable pricing of PCS based on consistent renewal of PCS priced at consistent dollar amounts, it may be appropriate for the entity to consider PCS renewals stated as a constant percentage of the license fee to determine an observable stand-alone selling price for PCS. This approach may be appropriate when the entity routinely prices PCS as a consistent percentage of the license fee, the entity has consistent pricing practices, and the resulting stand-alone selling price results in an allocation that is consistent with the overall allocation objective.

However, when an entity determines that an observable stand-alone selling price for the PCS does not exist, the 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 (whether priced as a fixed dollar amount or as a percentage of the license fee), a concentration of those amounts around a particular price may help support a stand-alone selling price.

Refer to Section 7.3.3.6 for additional information about using a range to estimate a stand-alone selling price.

Changing Lanes — Concentration of Separate Sales Versus Renewal Rate Approach

Generally, we believe that if an entity was previously able to establish VSOE of selling price for PCS under legacy U.S. GAAP on the basis of a concentration of separate sales of PCS, that amount may be used as the stand-alone selling price for PCS upon adoption of the new revenue standard as long as the entity’s current pricing and sales policies are maintained.
However, ASC 985-605 also provides specific guidance on determining VSOE of selling price for PCS by reference to the PCS renewal rate (the "renewal rate approach"). The renewal rate approach allows VSOE of selling price for PCS to be established on a contract-by-contract basis if the PCS renewal rate is substantive. 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 legacy accounting guidance. That is, the prices, or the percentages of the license fee, at which stand-alone sales of PCS occur may not be 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.

7.3.3.2 Residual Approach to Estimating Stand-Alone Selling Prices and Allocating the Transaction Price When a Value Relationship Exists

In the software industry, various factors may make it challenging for an entity that has entered into a contract with a customer to determine the stand-alone selling prices of goods and services promised in the contract. Such factors may include, but are not limited to, (1) highly variable or uncertain pricing, (2) lack of stand-alone sales for one or more goods or services, and (3) pricing interdependencies such that the selling price of one good or service is used to determine the selling price of another good or service in the same contract.

ASC 606 provides guidance on determining stand-alone selling prices, including the guidance in ASC 606-10-32-34(c) on using the residual approach to estimate stand-alone selling prices when prices are highly variable or uncertain. In addition, a combination of methods may be used in accordance with ASC 606-10-32-35 if two or more goods or services have highly variable or uncertain stand-alone selling prices. However, ASC 606 does not provide guidance on estimating the stand-alone selling price of a good or service when the price of that good or service is dependent on the price of another good or service in the same contract.

Entities in the software industry often sell PCS to customers in conjunction with a software license. Sometimes, PCS is priced as a percentage of the contractually stated selling price of the associated software license (e.g., 20 percent of the net license fee), including upon renewal. In these circumstances, as noted in Section 7.3.3.1, if an entity does not have observable pricing of PCS based on renewals of PCS priced at consistent dollar amounts, it may be appropriate for the entity to consider PCS renewals stated as a consistent percentage of the license fee to determine the observable stand-alone selling price for PCS. That is, even if an entity's license pricing is highly variable and the dollar pricing of PCS in stand-alone sales (i.e., renewals) is therefore also highly variable, the observable stand-alone selling price of PCS may still be established if PCS renewals are priced at a consistent percentage of the license fee, the entity has consistent pricing practices, and the stand-alone selling price results in an allocation that is consistent with the overall allocation objective.

Although the new revenue standard includes the residual approach as a suitable method for estimating the stand-alone selling price of a good or service in a contract, use of the residual approach is intended to be limited to situations in which the selling price of the good or service is highly variable or uncertain. Before applying the residual approach, an entity should consider whether (1) it has an observable stand-alone selling price for the good or service or (2) it can estimate the stand-alone selling price by using another method (e.g., adjusted market assessment or expected cost plus a margin approach). When the entity cannot determine the stand-alone selling price of the good or service by using another estimation method (e.g., because the stand-alone selling prices of the license and PCS, respectively, are highly
variable), it may be appropriate to apply the residual approach. In some instances, a combination of approaches may be needed to determine stand-alone selling prices and the resulting transaction price allocation. On the basis of available data and established internal pricing strategies and practices related to licenses and PCS, an entity may determine that it has established a “value relationship” between the license and the PCS. If this value relationship is sufficiently consistent, the entity may use it to estimate the stand-alone selling prices of the license and PCS, respectively. For example, if the PCS is consistently priced and renewed at 20 percent of the net license fee, the entity may conclude that it is appropriate to consistently allocate 83 percent of the transaction price to the license (1 ÷ 1.2) and 17 percent to the PCS (0.2 ÷ 1.2).

In addition, if a license is not sold separately because it is always bundled with PCS, the entity might analyze its historical pricing for that bundle and conclude that such pricing is highly variable. If the bundle also includes another good or service (e.g., professional services) for which there is an observable stand-alone selling price, a residual approach may be appropriate for determining the combined stand-alone selling price for the license and PCS bundle if the resulting estimated stand-alone selling price is reasonable.

Example 7-1 below illustrates these concepts.

**Example 7-1**

Entity X is a software vendor that licenses its software products to customers. The entity has determined that its licenses are functional IP in accordance with ASC 606-10-55-59.

Entity X enters into a contract with a customer to provide a perpetual software license bundled with one year of PCS and professional services in return for $100,000. While PCS and professional services are sold on a stand-alone basis, the license is never sold separately (i.e., it is always sold with PCS). Entity X concludes that the license, PCS, and professional services represent distinct performance obligations.

The contractually stated selling prices are as follows:

- **License** — $70,000.
- **PCS** — $14,000 (20 percent of $70,000).
- **Professional services** — $16,000.

After analyzing sales of the bundled license and PCS (the “bundle”), X concludes that the pricing for the bundle is highly variable and that a residual approach is appropriate in accordance with ASC 606-10-32-34(c).

Entity X has an observable stand-alone selling price for professional services of $25,000. In addition, the PCS is consistently priced (and may be renewed) at 20 percent of the net license fee stated in the contract (for simplicity, a range is not used). Entity X determines that it has observable data indicating that there is a value relationship between the perpetual license and the PCS since the PCS is consistently priced at 20 percent of the contractually stated selling price of the license, including on a stand-alone basis upon renewal. Consequently, X concludes that the stand-alone selling price of the PCS is equal to 20 percent of the selling price of the license.

We believe that the two alternatives described below ("Alternative A" and "Alternative B") are acceptable methods for allocating the transaction price to the performance obligations. To determine which alternative is more appropriate, an entity should consider the facts and circumstances of the arrangement. For example, we believe that when an entity has no (or insufficient) observable data available to determine the stand-alone selling price for the PCS, it generally would not be appropriate to use Alternative B.
Example 7-1 (continued)

Alternative A

Since the pricing of the bundle that comprises the license and the PCS is highly variable and there is an observable stand-alone selling price for the professional services, X may apply the residual approach to determine the stand-alone selling price of the bundle (step 1). If the resulting amount allocated to the bundle is reasonable and consistent with the allocation objective, X may then use the value relationship to determine how much of the transaction price that remains after allocation to the professional services should be allocated between the license and the PCS (step 2).

Step 1

Under step 1, X would determine the residual transaction price to be allocated to the bundle as follows:

<table>
<thead>
<tr>
<th>Total transaction price</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: observable SSP (professional services)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Residual transaction price</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

Step 2

Next, under step 2, X would allocate the residual transaction price to the license and PCS as follows:

| Residual transaction price | $75,000 |
| PCS value relationship (% of license) | 20% |
| PCS value relationship (% of bundle) | 17% (0.2 ÷ 1.2) |
| Transaction price allocated to PCS | $12,750 ($75,000 × 17%) |
| Transaction price allocated to license | $62,250 ($75,000 × 83%) |

The table below summarizes the allocation of the total transaction price to the performance obligations.

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Contract Price</th>
<th>SSP</th>
<th>SSP Method(s)</th>
<th>Relative SSP (%)*</th>
<th>Allocated Amount**</th>
<th>% of License SSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional services</td>
<td>$16,000</td>
<td>$25,000</td>
<td>Observable SSP</td>
<td>25%</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>PCS</td>
<td>14,000</td>
<td>12,750</td>
<td>Residual and value relationship</td>
<td>13%</td>
<td>12,750</td>
<td>20%</td>
</tr>
<tr>
<td>License</td>
<td>70,000</td>
<td>62,250</td>
<td>Residual and value relationship</td>
<td>62%</td>
<td>62,250</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
<td>$100,000</td>
<td>100%</td>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* To calculate the relative stand-alone selling price percentage, X would divide the stand-alone selling price of each performance obligation by the sum of all of the performance obligations’ respective stand-alone selling prices.

** To calculate the amount allocated to each performance obligation, X would multiply the relative stand-alone selling price percentage for the performance obligation by the total transaction (contract) price.
**Example 7-1 (continued)**

**Alternative B**

Given that the pricing of the bundle comprising the license and the PCS is highly variable, X may determine that the pricing of the license is also highly variable since it has observable data indicating that there is a consistent value relationship between the license and the PCS. In addition, X may determine that it has an observable stand-alone selling price for the PCS since PCS is consistently priced at 20 percent of the contractually stated selling price of the license. Since X has observable stand-alone selling prices for the PCS and professional services, respectively, it may apply the residual approach to determine the stand-alone selling price of the license if the resulting amount allocated to the license is reasonable and consistent with the allocation objective.

Entity X would allocate the transaction price as follows:

<table>
<thead>
<tr>
<th>Total transaction price</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>PCS value relationship</td>
<td>20%</td>
</tr>
<tr>
<td>Observable SSP (professional services)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Observable SSP (PCS)</td>
<td>$14,000</td>
</tr>
<tr>
<td>Residual transaction price (license)</td>
<td>$61,000</td>
</tr>
</tbody>
</table>

The table below summarizes the allocation of the total transaction price to the performance obligations.

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Contract Price</th>
<th>SSP</th>
<th>SSP Method(s)</th>
<th>Relative SSP (%)*</th>
<th>Allocated Amount**</th>
<th>% of License SSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional services</td>
<td>$16,000</td>
<td>$25,000</td>
<td>Observable SSP</td>
<td>25%</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>PCS</td>
<td>14,000</td>
<td>14,000</td>
<td>Observable SSP via value relationship</td>
<td>14%</td>
<td>14,000</td>
<td>23%</td>
</tr>
<tr>
<td>License</td>
<td>70,000</td>
<td>61,000</td>
<td>Residual</td>
<td>61%</td>
<td>61,000</td>
<td></td>
</tr>
<tr>
<td>**</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
<td>100%</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

* To calculate the relative stand-alone selling price percentage, X would divide the stand-alone selling price of each performance obligation by the sum of all of the performance obligations’ respective stand-alone selling prices.

** To calculate the amount allocated to each performance obligation, X would multiply the relative stand-alone selling price percentage for the performance obligation by the total transaction (contract) price.

In selecting an appropriate alternative to determine a stand-alone selling price in accordance with ASC 606-10-32-33, an entity should 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” and should “maximize the use of observable inputs.” Further, any allocation achieved through the use of the residual method should be (1) assessed for reasonableness and (2) consistent with the allocation objective in ASC 606-10-32-28.

While we believe that both of the alternatives discussed in Example 7-1 are acceptable methods for allocating the transaction price to the performance obligations, we acknowledge that practice may evolve over time. As practice evolves, the applicability of the alternatives described above is subject to change. Companies should continue to monitor changes in interpretations and consider consulting with their accounting advisers.
7.3.3.3 **Different Stand-Alone Selling Price for the Same Good or Service in a Single Contract**

Example 7-2 below illustrates how the stand-alone selling price should be determined when the specified contract price for the same product changes over the term of the arrangement.

**Example 7-2**

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.

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. 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. However, 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.

7.3.3.4 **Different Selling Price for the Same Good or Service to Different Customers**

Example 7-3 below illustrates how a product’s stand-alone selling price should be determined when the product is sold to different customers under separate contracts that each specify a different selling price.

**Example 7-3**

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.

As previously noted, 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. 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.
Example 7-3 (continued)

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 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.

7.3.3.5 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 use forward-curve pricing by default 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.
7.3.3.6 Using a Range When Estimating a Stand-Alone Selling Price

Throughout ASC 606, the FASB uses the term “standalone selling price,” which is defined in ASC 606-10-20 and the ASC master glossary as the “price at which an entity would sell a promised good or service separately to a customer.” In the Codification’s definition, the FASB refers to the term in the singular rather than the plural. In ASC 606, this word choice is further emphasized in illustrative examples in which the stand-alone selling price is always expressed as a single-point observation or estimate of value (e.g., in Example 33, the directly observable stand-alone selling price of Product A is $50, and the estimated stand-alone selling price of Product B under an adjusted market approach is $25).

As a result, some have questioned whether the singular form of the defined term and the illustrations in the examples would preclude an entity from using anything other than a single-point observation or estimate as the stand-alone selling price (i.e., whether the guidance in ASC 606 precludes an entity from using a range of observations or estimates to establish a stand-alone selling price).

We believe that 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 concentrated, 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”). See Section 7.3.3.6.1 below for additional information about determining the appropriate range to estimate a stand-alone selling price.

7.3.3.6.1 Determining the Appropriate Range

When a range is used to estimate the stand-alone selling price, questions have arisen about how to determine whether the range is truly indicative of the stand-alone selling price.

Some entities (e.g., companies in the software industry) have developed a practice of estimating the stand-alone selling price as a range by demonstrating that a certain number of observable transactions are sufficiently clustered around a midpoint. For example, on the basis of an analysis of historical data (i.e., observable pricing), an entity may use a bell-shaped curve approach and determine that 75 percent of the sales of a particular good are priced within 15 percent of $5\(^1\) (the midpoint) in either direction. Therefore, the stand-alone selling price range is $4.25 to $5.75. Both the distribution (i.e., width) of the range and the percentage of transactions clustered around the midpoint within that distribution (i.e., concentration) are important factors to consider in the determination of whether a range is truly indicative of the stand-alone selling price for a particular good or service.\(^2\)

ASC 606 does not prescribe or preclude any method for estimating the stand-alone selling price (exclusive of conditions that must be met for an entity to use the residual method). Likewise, ASC 606 does not establish any bright lines regarding which values or ranges are indicative of the stand-alone selling price, including the width and concentration of a given range. Instead, ASC 606 states that the stand-alone selling price of each distinct good or service should be a value “that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.”

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\(^1\) Some entities may instead establish the stand-alone selling price by using historical data on discounts off the list price. For example, if an entity consistently priced a particular good or service at 40 percent off the list price, the entity may establish the midpoint as 60 percent of the list price (100 percent less the 40 percent discount), assuming that a sufficient number of transactions were discounted within a reasonable range of that midpoint. This section does not address (1) the use of a discount off the list price to establish the stand-alone selling price range or (2) the determination of whether the use of historical discounting data is sufficient and appropriate for establishing the stand-alone selling price.

\(^2\) Some entities may instead apply a method similar to a bell-shaped curve approach to determine a single-point estimate of the stand-alone selling price of a performance obligation (e.g., by using the midpoint within the distribution as the stand-alone selling price). This section addresses only circumstances in which the stand-alone selling price is determined as a range.
Since the stand-alone selling price determined by using a range must meet the allocation objective in ASC 606-10-32-28, we believe that a particular range may not be appropriate if the concentration is too low, the width is too great, or both. For example, a stand-alone selling price range in which 60 percent of transactions fall within plus or minus 40 percent of a midpoint would most likely be too wide to meet the allocation objective. Likewise, a stand-alone selling price range in which 10 percent of transactions fall within plus or minus 15 percent of a midpoint would most likely not be sufficiently concentrated to meet the allocation objective. Entities must balance the narrowness of distribution with the adequacy of the concentration. That is, for an entity to establish the stand-alone selling price by using a range, both the concentration of transactions around the midpoint and the width thereof must be reasonable. For example, we believe that if an entity has maximized the use of observable inputs and has considered all reasonably available information, the entity would most likely meet the allocation objective in ASC 606-10-32-28 when using a stand-alone selling price range that (1) encompasses the majority of the relevant transactions (i.e., greater than 50 percent) and (2) has a width extending no greater than 20 percent from the midpoint in either direction.

We also believe that if there are not enough transactions within a reasonably narrow range, further disaggregation of the data (e.g., by contract value and geography in addition to product type) may be appropriate for determining reasonable stand-alone selling price ranges.3

If the resulting range does not meet the allocation objective after an entity has disaggregated the population of transactions, maximized the use of observable inputs, and considered all reasonably available information, the entity may need to apply other methods to establish the stand-alone selling price.

7.3.3.6.2 Allocation Considerations When the Stand-Alone Selling Price Is Established as a Range

An entity that establishes the stand-alone selling price as a range for a particular good or service will need to implement and consistently apply a policy related to when a contractually stated price does not represent the stand-alone selling price for any performance obligation (e.g., the contractually stated price is not within the established stand-alone selling price range) and reallocation is required. If a contractually stated price falls within the established stand-alone selling price range, it is considered “at stand-alone selling price,” and reallocation is therefore unnecessary unless required by other performance obligations in the contract (i.e., because the contractually stated price of another performance obligation is not at its stand-alone selling price). By contrast, if a contractually stated price is outside the stand-alone selling price range, reallocation is required. Accordingly, an entity will need to make a policy election regarding the point in the range that it will use for allocating the transaction price to each performance obligation on the basis of the stand-alone selling price. The following points are possible alternatives (not all-inclusive):

- The midpoint in the range.
- The outer point in the range, which would be:
  - The high point in the range when the contractually stated price is greater than the high point in the range.
  - The low point in the range when the contractually stated price is less than the low point in the range.
- The low point in the range.
- The high point in the range.

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3 The level of disaggregation may depend, in part, on an entity’s pricing policies and practices.
Once an entity elects a policy, the entity must ensure that the policy is consistently applied and that the resulting allocation meets the allocation objective in ASC 606-10-32-28.

**7.4 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 Codification example in Section 7.2). In accordance with the general allocation principle discussed in Section 7.2, the discounted transaction price is allocated proportionately to each distinct good and service on the basis of its relative stand-alone selling price. 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 paragraph 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 paragraph 606-10-32-37, but the Boards expected that this could occur in only rare cases.

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:

<table>
<thead>
<tr>
<th>Product</th>
<th>Standalone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$ 40</td>
</tr>
<tr>
<td>Product B</td>
<td>55</td>
</tr>
<tr>
<td>Product C</td>
<td>45</td>
</tr>
<tr>
<td>Total</td>
<td>$ 140</td>
</tr>
</tbody>
</table>

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.
**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:

<table>
<thead>
<tr>
<th>Product</th>
<th>Standalone Selling Price</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$ 40</td>
<td>Directly observable (see paragraph 606-10-32-32)</td>
</tr>
<tr>
<td>Products B and C</td>
<td>$ 60</td>
<td>Directly observable with discount (see paragraph 606-10-32-37)</td>
</tr>
<tr>
<td>Product D</td>
<td>$ 30</td>
<td>Residual approach (see paragraph 606-10-32-34(c))</td>
</tr>
<tr>
<td>Total</td>
<td>$ 130</td>
<td></td>
</tr>
</tbody>
</table>

**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.
Examples 7-4 and 7-5 below further illustrate how an entity may allocate a discount in a contract.

**Example 7-4**

Entity W regularly sells Item A, Item B, and Item C on a stand-alone basis. The stand-alone selling price (SSP) of each item is shown in the following table:

<table>
<thead>
<tr>
<th>Item</th>
<th>SSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ 30</td>
</tr>
<tr>
<td>B</td>
<td>70</td>
</tr>
<tr>
<td>C</td>
<td>50</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Date</th>
<th>Deliverable</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X1</td>
<td>Item A</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>Item B</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>Item C</td>
</tr>
</tbody>
</table>

Assume that W also sells bundles regularly at combined prices as follows:

<table>
<thead>
<tr>
<th>Bundle</th>
<th>Price</th>
<th>Combined SSP</th>
<th>Discount in Bundle</th>
</tr>
</thead>
<tbody>
<tr>
<td>A + B</td>
<td>$ 85</td>
<td>$30 + $70 = $100</td>
<td>$ 15</td>
</tr>
<tr>
<td>A + C</td>
<td>65</td>
<td>$30 + $50 = $80</td>
<td>15</td>
</tr>
<tr>
<td>B + C</td>
<td>105</td>
<td>$70 + $50 = $120</td>
<td>15</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Item</th>
<th>SSP</th>
<th>% of Total SSP</th>
<th>Total Discount to Allocate</th>
<th>Discount Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ 30</td>
<td>20.0</td>
<td>$ 15</td>
<td>$ 3</td>
</tr>
<tr>
<td>B</td>
<td>70</td>
<td>46.7</td>
<td>15</td>
<td>7</td>
</tr>
<tr>
<td>C</td>
<td>50</td>
<td>33.3</td>
<td>15</td>
<td>5</td>
</tr>
</tbody>
</table>

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 7-5

Assume the same facts as in Example 7-4, except that the entity regularly sells bundles at combined prices as follows:

<table>
<thead>
<tr>
<th>Bundle</th>
<th>Price</th>
<th>Combined SSP</th>
<th>Discount in Bundle</th>
</tr>
</thead>
<tbody>
<tr>
<td>A + B</td>
<td>$ 85</td>
<td>$30 + $70 = $100</td>
<td>$ 15</td>
</tr>
<tr>
<td>A + C</td>
<td>65</td>
<td>$30 + $50 = $80</td>
<td>15</td>
</tr>
<tr>
<td>B + C</td>
<td>120</td>
<td>$70 + $50 = $120</td>
<td>0</td>
</tr>
</tbody>
</table>

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).

7.4.1 Application of the Discount Allocation Guidance to Goods or Services Not Sold Separately

Generally, for the criterion in ASC 606-10-32-37(a) to be met, the entity will regularly sell and therefore have observable prices for all of the performance obligations in the contract to allocate a discount to one or more (rather than all) of the performance obligations. However, there may be instances in which an entity does not regularly sell each distinct good or service, but regularly sells some of the distinct goods and services as a bundle and regularly sells other distinct goods and services separately. In these cases, an entity may be able to conclude that the discount is allocable to the bundle of distinct goods and services.

This determination requires judgment. In all cases, an entity should maximize the use of observable evidence when determining stand-alone selling prices and allocating discounts. An entity should exercise caution when considering whether to allocate a discount in an arrangement to a distinct good or service that is not sold separately since the stand-alone selling price needs to be estimated.

Example 7-6 below illustrates how an entity may allocate a discount to a bundle of distinct goods and services.
Example 7-6

Company X enters into a contract to sell License A, Service B, and Service C. In addition, X regularly sells, and therefore has observable evidence of sales of, a bundle consisting only of License A and Service B ("Bundle A + B") for $50 and also regularly sells Service C for $20.

The tables below show the stand-alone selling price of each distinct good and service and each bundle of distinct goods and services that X sells.

<table>
<thead>
<tr>
<th>Distinct Good or Service</th>
<th>SSP</th>
<th>Observable Stand-Alone Sales?</th>
<th>Bundle</th>
<th>Observable Sales Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>License A</td>
<td>$ 40</td>
<td>No</td>
<td>A + B</td>
<td>$ 50</td>
</tr>
<tr>
<td>Service B</td>
<td>25</td>
<td>Yes</td>
<td>A + C</td>
<td>N/A</td>
</tr>
<tr>
<td>Service C</td>
<td>20</td>
<td>Yes</td>
<td>B + C</td>
<td>N/A</td>
</tr>
<tr>
<td>Total</td>
<td>$ 85</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Scenario 1: Contract Price = $70

As shown below, the value of the discount (in dollars) in this scenario is the same for (1) X’s observable and regular sales of Bundle A + B and (2) the contract that requires X to transfer License A, Service B, and Service C.

<table>
<thead>
<tr>
<th>65</th>
<th>Total of respective SSPs of License A and Service B purchased individually</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>Observable price of Bundle A + B</td>
</tr>
<tr>
<td>15</td>
<td>Discount for purchasing Bundle A + B</td>
</tr>
<tr>
<td>15</td>
<td>Incremental discount for purchasing Service C (in addition to Bundle A + B)</td>
</tr>
</tbody>
</table>

Since the observable sales price of Bundle A + B plus the observable sales price of Service C is equal to the contract price, there is no incremental discount for purchasing Service C in addition to Bundle A + B. Accordingly, X should attribute to Bundle A + B the discount of $15 off the total of License A’s and Service B’s respective stand-alone selling prices to arrive at the observable selling price of License A and Service B when sold together.

If necessary (e.g., if the time at which control of License A is transferred is different from when control of Service B is transferred), $50 of consideration (inclusive of the discount of $15) should be allocated between License A and Service B on a relative stand-alone selling price basis (step 2 allocation in the table below). In this fact pattern, the absence of observable stand-alone sales of License A does not prohibit the application of the guidance on allocating discounts in ASC 606-10-32-27 to Bundle A + B. Note, however, that the guidance could not be applied if X lacked observable stand-alone selling prices for either Service C or Bundle A + B.
Example 7-6 (continued)

The resulting allocations are as follows:

<table>
<thead>
<tr>
<th>Distinct Good or Service</th>
<th>SSP Value</th>
<th>SSP %</th>
<th>Contract Value</th>
<th>Relative SSP Allocation</th>
<th>SSP Value</th>
<th>SSP %</th>
<th>Relative SSP Allocation</th>
<th>Final Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>License A</td>
<td>$ 50</td>
<td>71%</td>
<td>$ 50</td>
<td>$ 40</td>
<td>62%</td>
<td>$ 31</td>
<td>$ 31</td>
<td></td>
</tr>
<tr>
<td>Service B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service C</td>
<td>20</td>
<td>29%</td>
<td>20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>$ 70</td>
<td>100%</td>
<td>$ 70</td>
<td>$ 60</td>
<td>100%</td>
<td>$ 50</td>
<td>$ 70</td>
<td></td>
</tr>
</tbody>
</table>

**Scenario 2: Contract Price = $60**

As shown below, when the contract price for purchasing License A, Service B, and Service C is $60, the contract includes a $25 discount in comparison with the sum of the stand-alone selling prices of License A, Service B, and Service C. Because the $25 discount in this contract is not the same as the $15 discount that a customer receives when purchasing License A and Service B together, the $25 discount must be allocated to each distinct good or service in the contract.

| $ 65 | SSP of A and B purchased individually |
| 50   | Observable price of Bundle A + B      |
| $ 15 | Discount for purchasing Bundle A + B  |

Because the discount for purchasing Bundle A + B ($15) is not substantially the same as the discount provided in the contract ($25), the criterion in ASC 606-10-32-37(c) is not met. Therefore, X may not allocate the discount in the contract entirely to Bundle A + B. Rather, the $25 discount should be allocated to each distinct good or service on a relative stand-alone selling price basis. The resulting allocations are as follows:

<table>
<thead>
<tr>
<th>Distinct Good or Service</th>
<th>SSP Value</th>
<th>SSP %</th>
<th>Contract Value</th>
<th>Relative SSP Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>License A</td>
<td>$ 40</td>
<td>47%</td>
<td>$ 28</td>
<td></td>
</tr>
<tr>
<td>Service B</td>
<td>25</td>
<td>29%</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Service C</td>
<td>20</td>
<td>24%</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 85</td>
<td>100%</td>
<td>$ 60</td>
<td></td>
</tr>
</tbody>
</table>
Connecting the Dots — 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 legacy 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.
7.4.2 Allocation of a Premium or Surplus

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.

Before assessing how to allocate a premium or surplus, given that this scenario is expected to be relatively uncommon, 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).

7.5 Allocation of Variable Consideration

As discussed in Section 7.4, 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 or distinct goods or services. 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). |
Chapter 7 — Step 4: Allocate the Transaction Price to the Performance Obligations

### ASC 606-10 (continued)

**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.

### 7.5.1 Codification 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.

**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.
ASC 606-10 (continued)

**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.

### 7.5.2 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 or distinct goods or services. Because discounts may be in the form of variable consideration (i.e., 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 variable discount.
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 in ASC 606-10-32-39 through 32-41 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.

The above issue is addressed in Q&A 38 (compiled from previously issued TRG Agenda Papers 31 and 34) of the FASB staff’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

There are several approaches to determining the amount that represents a discount rather than variable consideration. However, an entity should ensure that the approach selected results in an allocation that is consistent with the criteria in ASC 606-10-32-40, including the allocation objective in ASC 606-10-32-28.

The approaches are as follows:

- **Approach 1** — An 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, the 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.

- **Approach 2** — An 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 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.

- **Approach 3** — An 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 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.

Example 7-7 below illustrates the application of the above approaches.
Example 7-7

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:

<table>
<thead>
<tr>
<th>Outcome 1</th>
<th>Outcome 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed consideration</td>
<td>$ 225</td>
</tr>
<tr>
<td>Variable consideration</td>
<td>0</td>
</tr>
<tr>
<td>Total transaction price</td>
<td>225</td>
</tr>
<tr>
<td>Sum of products' respective stand-alone selling prices ($100 + $200)</td>
<td>300</td>
</tr>
<tr>
<td>Discount</td>
<td>75</td>
</tr>
</tbody>
</table>

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).

Because the performance bonus is related to productivity enhancements achieved by Product B, the entity concludes that the criterion in ASC 606-10-32-40(a) is 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 Product A and Product B. That allocation should be consistent with the criterion in ASC 606-10-32-40(b).

Approach 1 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:

<table>
<thead>
<tr>
<th>Potential Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SSP</strong></td>
</tr>
<tr>
<td>Product A</td>
</tr>
<tr>
<td>Product B</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>
Example 7-7 (continued)

Under Approach 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 recognize $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.

Under Approach 2, if the amounts discussed above are used across a portfolio of homogeneous contracts and the entity estimates that it would be entitled to a performance bonus of $40 (determined in accordance with ASC 606-10-32-8(a)), 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 Product A and Product B in accordance with the guidance in ASC 606-10-32-36 through 32-38 as follows:

<table>
<thead>
<tr>
<th>Potential Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SSP</strong></td>
</tr>
<tr>
<td>Product A</td>
</tr>
<tr>
<td>Product B</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

Under Approach 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 recognize $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.

Under Approach 3, if the amounts discussed 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 Product A and Product B in accordance with the guidance in ASC 606-10-32-36 through 32-38 as follows:

<table>
<thead>
<tr>
<th>Potential Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SSP</strong></td>
</tr>
<tr>
<td>Product A</td>
</tr>
<tr>
<td>Product B</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

Under Approach 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 recognize $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 approaches 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, Approach 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 objective.

### 7.5.3 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 5.3.3.1 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.
Chapter 7 — Step 4: Allocate the Transaction Price to the Performance Obligations

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.

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 paragraph 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.

The guidance in ASC 606-10-32-39 through 32-41 specifically addresses the allocation of variable consideration to one or more, but not all, performance obligations (or distinct goods or services promised in a series) but is silent on whether a similar allocation of fixed consideration is acceptable. However, Example A of Implementation Q&A 45 (compiled from previously issued TRG Agenda Papers 39 and 44) includes a declining fixed price per unit for variable quantities. In that example, it would be acceptable to allocate the fixed price attributed to each variable quantity even when the fixed price per unit declines over time. This is because such consideration represents variable consideration and doing so would meet the allocation objective when (1) the declining price is intended to reflect changes in market terms or (2) the changes in price are substantive and linked to changes in either the entity’s cost of fulfilling the obligation or the value provided to the customer.

Although Example A illustrates a situation in which there is a declining fixed unit price for variable quantities, we believe that the same concepts apply to the allocation of fixed elements of consideration provided that the contract also includes elements of variable consideration that meet the criteria to be allocated to one or more, but not all, performance obligations. That is, we believe that an entity must consider the total transaction price (i.e., both fixed and variable components) when performing an evaluation under ASC 606-10-32-40(b) to determine whether its application of the variable consideration allocation guidance described in that subparagraph is consistent with the overall allocation objective in ASC 606-10-32-28. Specifically, if the fixed consideration declines over time, allocating less of the fixed consideration to each successive period of a contract could be consistent with the objective behind allocating the total transaction price (i.e., the overall allocation objective in ASC 606-10-32-28) when (1) declining fixed consideration is linked to changes in the entity’s cost of providing the service or changes in the value provided to the customer and (2) the total transaction price also includes elements of variable consideration that meet the criteria to be allocated to one or more, but not all, distinct goods or services in a series.
Example 7-8

Entity L enters into a contract to provide 10 years of management service for an apartment complex to Customer C. In exchange for the service provided, C pays the following fees to L:

- **Base management fee** — Fixed annual fee that declines by 1 percent each year as a result of expected efficiencies and other expected cost reductions.
- **Incentive fee** — Variable annual fee based on 3 percent of C's rental revenues.
- **Reimbursement** — Payment of certain fulfillment costs incurred by L.

Entity L concludes that the management service meets the criteria in ASC 606-10-25-15 to be accounted for as a series of distinct services.

Under these facts, L can allocate the fixed consideration in the contract to each distinct increment of management service. The base management fee declines on an annual basis as a result of expected efficiencies and other expected cost reductions. In addition, there are variable elements of consideration that meet the criteria to be allocated to one or more, but not all, distinct goods or services in a series. For these reasons, we believe that L would meet the overall allocation objective in ASC 606-10-32-28 by allocating each annual amount of the base management fee, in combination with the variable consideration (the annual incentive fee, which is further discussed below), to a distinct annual year of service. Consequently, L will recognize less revenue from the base management fee in each year of the contract.

Entity L can allocate the variable consideration in the contract (i.e., the annual incentive fee) to each distinct increment of management service. The variable consideration in this example (i.e., the annual incentive fee) is similar to the variable payments in Example C of Implementation Q&A 45. The variability associated with the incentive fee is directly related to the distinct increments of management service provided by L (i.e., the rental income generated from the management service). Because the variability is related to each distinct increment of management service, allocating each annual incentive fee to a distinct annual year of service is consistent with the allocation objective in ASC 606-10-32-28.

Further, if the reimbursement of L’s fulfillment costs is directly related to L’s efforts to fulfill its promise to C, L can allocate that reimbursement to the period in which the costs were incurred. Doing so in that case would be consistent with the allocation objective in ASC 606-10-32-28.

Connecting the Dots — Allocating Fixed and Variable Consideration

Example 7-8 above illustrates a situation in which a single performance obligation results in multiple forms of consideration (i.e., both fixed consideration and multiple sources of variable consideration). As a result of the allocation conclusions above, the actual revenue recognized is likely to fluctuate during the contract period as the uncertainties associated with the sources of variable consideration are resolved. Consequently, revenue might be recognized in a pattern that suggests that multiple measures of progress are being used to determine the entity’s pattern of performance. As discussed in Section 8.5.3, an entity should use only a single measure of progress for each performance obligation identified in a contract. However, the pattern of revenue recognition that results from the allocations described in Example 7-8 is not attributable to the selection of multiple methods of measuring progress as part of step 5 (i.e., the pattern does not reflect multiple attribution). Rather, the pattern arises from the application of the transaction price allocation guidance as part of step 4.
Chapter 7 — Step 4: Allocate the Transaction Price to the Performance Obligations

7.5.4 Optional Exemption From Disclosure Requirement

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.

ASU 2016-20 includes the addition of an optional exemption to the new revenue standard’s guidance on required disclosures. The optional exemption provides 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 optional exemption are still required to disclose any fixed consideration allocated to outstanding performance obligations.

7.5.5 Application of the Variable Consideration Allocation Exception to Commodity Sales Contracts With Market- or Index-Based Pricing

Entities in commodity industries (e.g., oil and gas, power and utilities, mining and metals, and agriculture) may enter into sales contracts to transfer a specified quantity of commodities in exchange for market- or index-based pricing at the time the commodities are transferred.

Commodity sales contracts with market- or index-based pricing contain variable consideration since the ultimate amount to which entities in such contracts are entitled is unknown at contract inception. Consequently, entities that have entered into these contracts should evaluate the criteria in ASC 606-10-32-40 to determine whether the variable consideration allocation exception is met.

Generally, commodity sales contracts that contain only market- or index-based pricing will meet the criteria in ASC 606-10-32-40, and therefore qualify for the variable consideration allocation exception, as follows:

- The criterion in ASC 606-10-32-40(a) will generally be met because the variability is solely attributed to, and resolved as a result of, the market- or index-based price upon the transfer of each distinct commodity to the customer.
- The criterion in ASC 606-10-32-40(b) will generally be met because the market- or index-based price represents the amount of consideration to which the entity expects to be entitled upon the transfer of each distinct commodity. If the index-based price is unrelated to the commodity (e.g., oil indexed to inflation), the criterion in ASC 606-10-32-40(b) may not be met.

However, when commodity sales contracts with market- or index-based pricing also include fixed consideration or other types of variable consideration, entities will need to consider all of the payment terms to determine whether both of the criteria in ASC 606-10-32-40 are met.
Example 7-9

Company T enters into a contract with a customer to sell and deliver specified gallons of heating oil each day over a two-year period. The price of the heating oil is based on the New York Harbor No. 2 Heating Oil Spot Price (the “Pricing Index”) on the day that the heating oil is delivered to the customer.

Company T concludes that each gallon of heating oil represents a separate performance obligation (i.e., a distinct good). That is, each gallon of heating oil is separately identifiable and capable of benefiting the customer on its own. In addition, control of each gallon of heating oil is transferred at the time of delivery (i.e., at a point in time).

Because of the variable consideration in the contract that arises from the Pricing Index, T evaluates whether the contract meets the criteria in ASC 606-10-32-40 and therefore qualifies for the variable consideration allocation exception. In its evaluation, T makes the following determinations:

- The criterion in ASC 606-10-32-40(a) is met because the daily Pricing Index (i.e., the variable consideration) is specifically related to T’s efforts to transfer the distinct goods each day (i.e., each daily quantity of heating oil).
- The criterion in ASC 606-10-32-40(b) is met because the Pricing Index reflects the amount of consideration to which T expects to be entitled upon the transfer of the distinct goods (i.e., each daily quantity of heating oil).

On the basis of these determinations, T concludes that it is appropriate to recognize revenue in an amount equal to the gallons of heating oil each day multiplied by the Pricing Index on the day the oil is delivered to the customer.

7.5.6 Accounting for Sponsorship Arrangements

Companies often enter into multiyear sponsorship arrangements with venues (e.g., sports stadiums) to promote their brand. For example, a beer company may enter into a contract with a football stadium to display its logo on the football field. Other examples of sponsorship arrangements include companies’ obtaining the naming rights to stadiums.

Many sponsorship arrangements are relatively long-term (e.g., five years or longer) and may contain stated price increases on an annual basis (e.g., 3 percent increase in the annual fee each year of the contract). Example 7-10 below illustrates these concepts.

Example 7-10

Chi Corp. owns an arena, which is used by a baseball team, the Streeterville Sluggers, to play its home games from April to October each year. In addition to baseball games, the arena holds other live events (e.g., concerts) that occur evenly throughout the year. The Streeterville Sluggers games constitute approximately 40 percent of the total live events held at the arena throughout the year. The number of other live events is subject to the duration of the team’s season (e.g., the team’s season will be longer if the team makes it into the playoffs).

On January 1, 20X8, Chi Corp. enters into a five-year noncancelable sponsorship agreement with Beer Inc., which allows Beer Inc.’s logo to be displayed throughout the arena. Chi Corp.’s promise to provide the sponsorship rights meets the criteria in ASC 606-10-25-27 to be satisfied over time.

Chi Corp. has concluded that the contract to provide sponsorship rights to Beer Inc. does not contain a lease under either ASC 840 or ASC 842.
Example 7-10 (continued)

In exchange for the sponsorship rights granted to Beer Inc., Beer Inc. agrees to pay Chi Corp. a fixed fee that increases by 5 percent each year as follows:

- Year 1: $1,000,000.
- Year 2: $1,050,000.
- Year 3: $1,102,500.
- Year 4: $1,157,625.
- Year 5: $1,215,506.

Chi Corp. has concluded that the annual fees stated in the contract are equal to the stand-alone selling price of the services provided in each annual period of the sponsorship. In addition, Chi Corp. has concluded that it does not meet the conditions in ASC 606-10-55-18 to apply the invoice practical expedient (see Section 8.5.8.1 for further discussion of the invoice practical expedient).

When assessing how to allocate the annual fees and recognize revenue, Chi Corp. must first evaluate the criteria in ASC 606-10-25-14(b) and 25-15 to determine whether the annual sponsorship rights it promised in a long-term sponsorship arrangement represent a series of distinct licenses (and therefore a single performance obligation) or multiple performance obligations (i.e., separate performance obligations for each annual period).

ASC 606-10-25-14(b) states that a series consists of "distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer." Further, ASC 606-10-25-15 provides the following two criteria that, if met, would establish that a series of distinct goods or services has the same pattern of transfer to the customer:

- "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."
- 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."

When assessing the criteria in ASC 606-10-25-14(b) and 25-15, Chi Corp. should evaluate the nature of its promise in the sponsorship arrangement and, more specifically, should consider whether the nature of its promise varies throughout the contract term (i.e., whether the promise in one annual period is substantially the same as the promise in other annual periods of the contract term).

If Chi Corp. concludes that the nature of its promise in the sponsorship arrangement is substantially the same in each year of the contract, the promise to provide sponsorship rights over the contract term would meet the criteria in ASC 606-10-25-14(b) and 25-15 to be accounted for as a series of distinct licenses, which are accounted for as a single performance obligation. Although the single performance obligation would consist of a series of distinct licenses, Chi Corp. concludes that it does not meet the criteria in ASC 606-10-32-40 to allocate consideration entirely to one or more, but not all, of the distinct periods within the series because no element of variable consideration exists. Therefore, Chi Corp. would recognize the transaction price (i.e., $5,525,631) by using a single measure of progress over the five-year contract term (e.g., ratably if Chi Corp. determines that time is an appropriate measure of progress). Recognizing revenue by using a time-based measure of progress would result in the creation of a contract asset in year 1, which would increase in years 2 and 3 of the contract and subsequently reverse in years 4 and 5 of the contract.

If, on the other hand, Chi Corp. concludes that the nature of its promise in the sponsorship arrangement is not substantially the same in each year of the contract, the promise to provide sponsorship rights over the contract term would not meet the criteria in ASC 606-10-25-14(b) and 25-15 to be accounted for as a series of distinct licenses. Rather, the contract would consist of five distinct performance obligations since the events occur evenly throughout the year (i.e., a distinct performance obligation for each annual period of the contract). Because the annual fees stated in the contract are equal to the stand-alone selling price of the services provided in each annual period of the sponsorship, Chi Corp. would allocate the stated annual fees in the contract to each annual period. Consequently, Chi Corp. would recognize revenue for each annual period equal to the amount billed to Beer Inc. for that period.
7.6 Changes in the Transaction Price

7.6.1 Allocating Changes in the Transaction Price

<table>
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<th>ASC 606-10</th>
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<tr>
<td><strong>32-42</strong> 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.</td>
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**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).

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 are identified after the contract modification.

7.6.2 Differentiating Changes in the Transaction Price From Contract Modifications

ASC 606-10-32-43 and 32-44 specify that an entity should allocate changes in the transaction price on the same basis as at contract inception. Application of this guidance may result in a cumulative catch-up adjustment to revenue for amounts allocated to satisfied performance obligations. In addition, ASC 606-10-32-45 states that an entity should account for changes in the transaction price that are triggered by a contract modification in accordance with the contract modification guidance in ASC 606-10-25-10 through 25-13.

An entity should consider whether the change in the price is due to (1) the resolution of variability that existed at contract inception or (2) a change in the scope or price (or both) of the contract that changes the parties’ rights and obligations after contract inception.

ASC 606-10-32-42 describes a change in the transaction price as 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.” A change in the transaction price could result from the resolution of variable consideration (e.g., achieving a performance bonus or qualifying for a volume rebate) that was part of the contract at inception. However, the contract does not always have to specifically identify forms of variable consideration for subsequent changes to be accounted for as a change in the transaction price. The following factors could suggest that subsequent changes in the transaction price do not constitute a contract modification:

- The entity has a history of granting price concessions to customers, which may or may not have been specifically negotiated.
- The selling prices of the goods or services are highly variable, and the entity has a demonstrated history of not enforcing payment of the stated sales price (e.g., the entity has granted extended payment terms and has a history of not enforcing payment of the full contract price).
- Changes in the transaction price result from customer satisfaction issues related to the underlying product or service.
On the other hand, a contract modification is described in ASC 606-10-25-10 as “a change in the scope or price (or both) of a contract that is approved by the parties to the contract. . . . 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.” Although contract modifications will usually result from negotiations between the parties after contract inception, finalizing the amount of concessions or other variable consideration may also require subsequent negotiations between the parties. Therefore, the existence of negotiations is not in itself determinative of whether a change represents a change in the transaction price or a contract modification. Further, while contract modifications often include the addition or removal of goods or services, they could occasionally occur without a change in the scope of the contract (i.e., only as a result of a change in price). The following factors could suggest that a change in the transaction price should be accounted for as a modification:

- Subsequent changes in market conditions suggest that there has been a substantial change in the market price of the goods or services that was not anticipated at contract inception, which resulted in the entity's agreeing to adjust the transaction price.
- The entity has no history of granting price concessions, and the price concession is not related to the quality of the transferred goods or services.
- The entity agreed to a reduction in the transaction price for remaining goods or services to induce its customer to enter into a contract for additional goods or services.
- Technological advances and competitive pressures that did not exist at contract inception result in a significant change in the price that the entity is willing to accept for its goods or services.

An entity will need to use judgment to determine whether a change in price is the result of a change in the transaction price or a contract modification, especially when the entity provides the customer with a price concession. In situations involving a price concession, an entity will need to consider whether the price concession should have been contemplated at contract inception and thus represents a change in the transaction price. As illustrated in Example 5, Case B, of the new revenue standard (ASC 606-10-55-114 through 55-116), this may be the case when the concession is related to product defects or service issues associated with products or services that have already been transferred to the customer. Had the product defects or service issues been anticipated at contract inception, the potential price concession would have been identified as a source of variable consideration under the contract.

Alternatively, a concession may result from a change in market conditions that could not have been anticipated at contract inception. The resulting change in the price of the contract changes the existing enforceable rights and obligations of the parties under the contract and should be accounted for as a contract modification in accordance with ASC 606-10-25-10 through 25-13.
Example 7-11 below illustrates the identification of and accounting for a change in the transaction price that results from a contract modification.

**Example 7-11**

Albus Inc. enters into a contract with Cherry Co. to deliver 120 standard widgets (each distinct) over a 12-month period for a fixed price of $100 per widget (total transaction price of $12,000). After 60 widgets are transferred (for which Albus Inc. recognizes $6,000 in revenue), a new competitor launches a competing product that is being sold for $65 per widget. Because of a change in the competitive landscape and to preserve its customer relationship, Albus Inc. agrees to lower the price for the remaining 60 widgets to $60 per unit.

Albus Inc. concludes that (1) its rights under the initial contract changed (having given up its right to $100 per widget) and (2) it should account for the change in the transaction price as a contract modification. Consequently, Albus Inc. applies the guidance in ASC 606-10-25-10 through 25-13. Since the remaining widgets to be transferred under the contract are distinct, Albus Inc. will recognize revenue of $3,600 ($60 × 60 units) as the remaining 60 widgets are transferred to Cherry Co.

In contrast to Example 7-11, Example 7-12 below illustrates the identification of and accounting for a change in the transaction price that does not result from a contract modification.

**Example 7-12**

Albus Inc. enters into a contract with Cherry Co. to deliver 120 standard widgets (each distinct) over a 12-month period for a fixed price of $100 per widget (total transaction price of $12,000). After 60 widgets are delivered, Cherry Co. identifies quality issues with the first 60 units delivered that require a small amount of rework. After negotiations, Albus Inc. agrees to grant Cherry Co. a concession of $20 per unit (a total concession of $2,400). Albus Inc. and Cherry Co. agree that the concession will be reflected in the selling price of the remaining 60 widgets (decreasing the price to $60 per widget for the remaining 60 widgets).

Albus Inc. determines that it should account for the concession as a change in the transaction price since it resulted from conditions that existed in the initial contract (quality issues in the transferred widgets). That is, because of the quality issue in the product (which will continue with the remaining widgets), Albus Inc. concludes that it had a right to consideration of only $80 per widget under the initial contract. Consequently, Albus Inc. applies the guidance in ASC 606-10-32-43 and 32-44. It records an immediate adjustment to revenue of $1,200 for the $20 per widget concession granted for units already transferred to Cherry Co. and will recognize revenue of $4,800 ($80 per widget) as the remaining 60 widgets are transferred to Cherry Co.

Refer to Chapter 9 for additional information about accounting for contract modifications.

### 7.7 Allocation Considerations for 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 6.4). 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.

In situations involving a contract with a customer that includes multiple performance obligations, questions have arisen about whether an adjustment to the transaction price resulting from a significant financing arrangement could be allocated to one or more, but not all, performance obligations.
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 allocate 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 allocation, 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 allocating 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 above issue is addressed in Implementation Q&A 37 (compiled from previously issued TRG Agenda Papers 30 and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.
Chapter 8 — Step 5: Determine When to Recognize Revenue

8.1 Objective and Background
8.2 Control
8.3 Two Models for Revenue Recognition — Based on Control
8.4 Revenue Recognized Over Time
8.5 Measuring Progress for Revenue Recognized Over Time
8.6 Revenue Recognized at a Point in Time
8.7 Repurchase Agreements
8.8 Customers’ Unexercised Rights — Breakage
8.9 Other Considerations in Step 5
8.1 Objective and Background

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<th>ASC 606-10</th>
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<tr>
<td><strong>25-23</strong> 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.</td>
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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.

Legacy revenue guidance draws on the notions of “earned” and “realized or realizable” in FASB Concepts Statement 5. In addition, it is often necessary in legacy 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 legacy U.S. GAAP is based on a completion of the earning process as demonstrated 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 generally 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 legacy 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), 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, legacy U.S. GAAP and IFRS Standards include guidance that make a distinction between goods and services, for example:

- **Services** — Under legacy U.S. GAAP, the guidance in ASC 605-35 (formerly SOP 81-1) is applied to production and construction contracts; and under legacy IFRS Standards, the guidance in IAS 11 is applied to similar contracts. In addition, other industry-specific guidance under legacy 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 legacy U.S. GAAP, entities typically apply SAB Topic 13 and the fundamentals of FASB Concepts Statement 5 to the sale of goods; and under legacy IFRS Standards, 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.

**Connecting the Dots — Two Separate Models or a Single Framework**

Legacy 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 legacy 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 [legacy] U.S. GAAP.”

In addition, since the various accounting literature in use was created over many years by different standard-setting bodies (e.g., the AICPA, EITF, and FASB), different accounting outcomes

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1 Quoted from the FASB’s 2008 discussion paper on the Board’s preliminary views on revenue recognition in contracts with customers.
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 Distinguishing Between “Goods” and “Services”**

Despite intending to create a single framework, the boards acknowledged (in a manner similar to legacy 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 accounting based on the disparate qualities of goods and services.

See further discussion in Sections 8.4, 8.5, and 8.6 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. 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.
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.

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.

• *“To 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.

• *“And 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.

**Connecting the Dots — 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 the legacy guidance of 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 Sections 8.3.1 and 8.3.2 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 those 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.

**Connecting the Dots — 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 and identified promised goods or services in step 2 is critical to determining when transfer of control occurs in step 5. As discussed in Section 8.1.1, 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 generally 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 Section 5.5 for additional information on determining whether a warranty represents a distinct service in the contract.

**Connecting the Dots — Assessing the Nature of the Promise**

Identifying the nature of the arrangement and 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 over time 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 8.9.5.

Sections 8.3.1 through 8.3.4 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.

**8.3.1 When Revenue Recognition Over Time Is Appropriate for Goods (e.g., Contract Manufacturing)**

An entity that is delivering goods (e.g., a contract manufacturer) 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 faithfully depicts the entity's performance to date for producing the product. Therefore, contract revenue should be recognized as the entity performs (i.e., as the product is produced) rather than when the product is delivered to the customer.

8.3.2 When Revenue Recognition Over Time Is Appropriate for Services (e.g., Construction)

An entity that provides a service (e.g., under a construction contract) cannot assume that it can recognize revenue over time. Rather, the entity needs 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 performance obligation 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.

8.3.3 Whether an Entity Is Free to Choose Whether to Recognize Revenue Over Time or at a Point in Time

The decision of whether to recognize revenue over time or at a point in time is not a free choice. 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.

### 8.3.4 Recognizing Revenue Over Time or at a Point in Time — Production of Customized Goods

An entity that recognized revenue at a point in time under legacy U.S. GAAP may be required to recognize revenue over time under ASC 606. In the FASB staff's view, revenue from certain contracts with customers (e.g., contracts for the production of customized goods) that would have been recognized at a point in time under legacy U.S. GAAP may need to be recognized over time under the new revenue standard because (1) the goods or services being provided may have no alternative use to the entity and (2) the entity may have an enforceable right to payment. To illustrate, the FASB staff cites the following fact pattern:

An entity has contracted with a customer to provide a manufacturing service in which it will produce 1,000 units of a product per month for a 2-year period. The service will be performed evenly over the 2-year period with no breaks in production. The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant upfront costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in paragraph 606-10-25-19. Additionally, the service is accounted for as a performance obligation satisfied over time in accordance with paragraph 606-10-25-27 because the units are manufactured specific to the customer (such that 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 has an enforceable right to payment (cost plus a reasonable profit margin). Therefore, the criteria in paragraph 606-10-25-15 have both been met.

The FASB staff cautions that while the example is not meant to illustrate that revenue from contracts for customized goods should always be recognized over time, an entity should not presume that it would continue to recognize revenue from such contracts at a point in time under the new revenue standard. Rather, the entity would need to assess the criteria in ASC 606-10-25-27 to determine whether it should recognize revenue over time. If none of those criteria are met, the entity should recognize revenue at a point in time.

The above issue is addressed in Implementation Q&A 54 (compiled from previously issued TRG Agenda Papers 56 and 60). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

### 8.4 Revenue Recognized Over Time

<table>
<thead>
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<th>ASC 606-10</th>
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<tr>
<td><strong>25-27</strong> 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:</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>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).</td>
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<tr>
<td>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).</td>
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2 Quoted from Q&A 54 of the FASB staff's *Revenue Recognition Implementation Q&As* (the “Implementation Q&As”).
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 should be recognized as the entity is performing) or (2) providing the customer with a good (and revenue should be recognized only when the entity finishes what it was obligated to do and the good is transferred or 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:
8.4.1 Meeting More Than One of the Criteria for Recognition of Revenue Over Time

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.

8.4.2 Application of ASC 606-10-25-27 to Contracts With a Very Short Duration

For contracts with a short duration (e.g., a one-year contract or a one-month contract), ASC 606 does not 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.

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. Depending on the timing of the transfer of control, the distinction could result in different accounting outcomes when control is transferred in multiple reporting periods. In addition, entities should consider the different disclosure requirements related to those performance obligations that are satisfied over time versus those that are satisfied at a point in time.

8.4.3 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). . . .

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.
ASC 606-10 (continued)

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 an 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 reperform the work 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.

**Connecting the Dots — 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.
The FASB staff discusses this issue in Implementation Q&A 50 (compiled from TRG Agenda
Papers 43 and 44), noting that the evaluation of the criterion in ASC 606-10-25-27(a) should take
into consideration “all relevant facts and circumstances, including the inherent characteristics
of the commodity, the contract terms, and information about infrastructure or other delivery
mechanisms.” In Implementation Q&A 50, the FASB staff further notes that the evaluation
should be performed in this manner “regardless of whether the contract is for the delivery of a
commodity or a widget.”

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 stand-alone
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.

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).

### 8.4.4 Customer Controls the Asset as It Is Created or Enhanced

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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: . . .</td>
</tr>
<tr>
<td>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). . .</td>
</tr>
<tr>
<td>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.</td>
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</table>

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 configuration or customization of computer hardware and software owned by the customer. Because the customer controls the work in process, the customer is benefiting from the entity’s performance as the entity performs.
Example 8-1

Entity B enters into a contract to manufacture a customized part for Customer L. To manufacture the part, B must purchase the raw materials from the supplier designated by L (i.e., B does not have discretion to select the supplier). Entity B places orders directly with the supplier, and it accepts and takes legal title to the raw materials directly from the supplier. The acceptability of the raw materials and work in process is B's responsibility, and the raw materials and work in process stay in B's physical possession throughout the manufacturing process. Title to the part, as well as the significant risks and rewards of ownership of the part, is transferred to L upon shipment of the part to L. The part is customized to L's specifications and has no alternative use to B. However, B does not have an enforceable right to payment and therefore fails to meet the criterion in ASC 606-10-25-27(c).

Entity B's contract with L also does not meet the criterion in ASC 606-10-25-27(b) for recognizing revenue over time, as supported by the following:

- Customer L does not accept, physically possess, or have title to the raw materials or work in process because B is manufacturing the customized part.
- Entity B has the risks and rewards of ownership of the raw materials and work in process until title to, and the risks and rewards of ownership of, the finished part are transferred to L.
- Although L has discretion in selecting the supplier for the raw materials, this does not give L control over the raw materials or the subsequent work in process.

The basis for the second criterion is consistent with the rationale for using the percentage of completion method for revenue recognition under legacy 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.

8.4.5 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: . . .

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.”

### 8.4.5.1 Alternative Use

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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<tbody>
<tr>
<td><strong>25-28</strong> 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.</td>
</tr>
<tr>
<td><strong>55-8</strong> 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.</td>
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<tr>
<td><strong>55-9</strong> 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.</td>
</tr>
<tr>
<td><strong>55-10</strong> 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.</td>
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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 readily 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 work.

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 may 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.

An entity's assessment of alternative use should be performed at contract inception and should not be updated unless there is a contract modification that substantively changes the performance obligation. In performing the assessment, the entity should consider the asset in its completed state when determining whether the asset can practically be readily redirected. Further, in addition to concluding that there is no alternative use, the entity must conclude that it has a right to payment for performance completed to date, which is further described in Section 8.4.5.2.

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**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.

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**Example 8-2**

A manufacturer of automobile parts enters into a contract with a customer for the initial production of 1,000 parts for the customer's new vehicle. The parts are highly customized and only compatible with the customer's new vehicle (i.e., the parts would not function in other vehicles). The contract provides the manufacturer with an enforceable right to payment for its performance throughout the contract period in accordance with ASC 606-10-25-27(c). There are no contractual restrictions preventing the manufacturer from redirecting the finished parts to a third party. However, since an aftermarket for the parts does not exist at contract inception and there are no other customers to which the part can be readily directed, the manufacturer is limited practically from redirecting the parts for another use.
Example 8-2 (continued)

In this example, the contract for the initial production of parts meets the criterion in ASC 606-10-25-27(c) for recognizing revenue over time. In accordance with ASC 606-10-25-27(c), an entity is required to recognize revenue over time if the asset being produced has no alternative use and the entity has an enforceable right to payment. ASC 606-10-25-28 further requires an entity to determine “at contract inception” whether the asset being produced has an alternative use. Since the manufacturer in this fact pattern is limited practically from redirecting the parts for another use (because no aftermarket exists at contract inception), the parts do not have an alternative use. Since the parts do not have an alternative use and, as noted above, the contract provides an enforceable right to payment for the manufacturer’s performance throughout the contract period, the criterion in ASC 606-10-25-27(c) would be met. However, once an aftermarket for the parts does exist, the manufacturer would be able to redirect the parts to another party, thereby creating an alternative use. At that point, the criterion in ASC 606-10-25-27(c) for recognizing revenue over time would no longer be met for future contracts to manufacture and deliver the parts (including any modifications to the original contract that substantively change the performance obligation).

We acknowledge that in other situations, a manufacturer of parts may believe that it is highly probable that an aftermarket for the parts will exist in the future (e.g., after the development stage). In these situations, entities will need to apply judgment and consider all of the relevant facts and circumstances, including, but not limited to, (1) historical evidence, (2) the quantity of the parts, (3) the nature of the parts, (4) the stage of development, (5) the existence of a contract, and (6) contract negotiations. Entities may want to consult with their accounting advisers in such situations.

Connecting the Dots — Assessing Alternative Use — Completed Asset Versus In-Production Asset

In Implementation Q&A 55 (compiled from TRG Agenda Papers 56 and 60), the FASB staff discusses whether an entity should consider the completed asset or the in-production asset when performing the “alternative use” assessment under ASC 606-10-25-27(c). The FASB staff’s analysis of this issue is illustrated in the following example:

An entity enters into a contract with a customer to build equipment. The entity is in the business of building custom equipment for various customers. The customization of the equipment occurs when the manufacturing process is approximately 75% complete. In other words, for approximately 75% of the manufacturing process, the in-process asset could be redirected to fulfill another customer’s equipment order (assuming there is no contractual restriction to do so). However, the equipment cannot be sold in its completed state to another customer without incurring a significant economic loss. The design specifications of the equipment are unique to the customer and the entity would only be able to sell the completed equipment at a significant loss.

The FASB staff notes in Implementation Q&A 55 that “[b]ecause the entity [in the example] cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state and, therefore, the asset does not have an alternative use.” Accordingly, regardless of the timing of the customization in the production process (i.e., when the good has no alternative use), the entity should consider whether the completed asset could be redirected to another customer without the need for significant rework on the customized good. If the completed asset is deemed to have no alternative use, that aspect of the criterion in ASC 606-10-25-27(c) would be met.
### 8.4.5.2 Enforceable 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.

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).
ASC 606-10 (continued)

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 at least an amount for performance completed to date in the event of a contract termination. However, payment terms by themselves do not support a determination of whether an entity has an enforceable right to payment for performance completed to date. Rather, the entity should evaluate whether it has an enforceable right to payment if the contract were to be terminated for reasons other than the entity’s failure to perform. For example, an entity may be paid only upon contract completion or may be paid entirely up front. In those circumstances, the entity must consider whether it has a right to demand or retain payment for performance completed to date if the contract were to be terminated.

The FASB and IASB 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 Example 8-4 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. Example 8-3 below illustrates this concept.

**Example 8-3**

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 construction of 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).

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.
Example 8-3 (continued)

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. Accordingly, X's contract with Y meets the condition in ASC 606-10-25-27(c) for recognition of revenue over time.

Connecting the Dots — 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.
**ASC 606-10 (continued)**

**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.

**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).
### ASC 606-10 (continued)

#### 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.

#### 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.

Example 8-4 below illustrates the determination of whether and, if so, how to recognize revenue from real estate sales and purchase agreements entered into before the completion of a property project.

Example 8-4

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 component.
Example 8-4 (continued)

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 may not obtain physical possession of or title to the property until
construction is completed.

Entity A should focus on criterion (c), and particularly on (1) whether an asset has been created with an
alternative use to the real estate developer and (2) 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).
Example 8-4 (continued)

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).

8.4.5.2.1 How and When an Entity Should Determine Whether It Has an Enforceable Right to Payment

In Implementation Q&A 56 (compiled from TRG Agenda Papers 56 and 60), the FASB staff discusses how and when an entity should determine whether it has an enforceable right to payment under ASC 606-10-25-27(c). The staff notes that under ASC 606-10-55-14, an entity should consider the following factors in addition to assessing the terms of the contract:

- “[L]egislation, administrative practice, or legal precedent that 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.”
- “[R]elevant legal precedent that indicates that similar rights to payment for performance completed to date in similar contracts [have] no binding legal effect.”
- An “entity’s customary business practice of choosing not to enforce a right to payment that has resulted in the right being rendered unenforceable in that legal environment.”

The determination should be made at contract inception. To illustrate its analysis, the FASB staff provides the following example:

For each of the last five years, an entity has received an order from a customer for 300 custom ice cream machines. The specifications of the ice cream machines are unique to the customer. In anticipation of the customer’s order this year, the entity starts production of the custom ice cream machines before there is a contract between the parties in the current year. The entity is willing to take the risk of beginning to manufacture custom units before there is a contract because (a) the customer has predictable purchasing behavior and (b) the entity has knowledge of the customer’s performance in the current year and plans for growth from the customer’s public disclosures. The entity and the customer later enter into a contract (that meets all of the criteria in Step 1 of Topic 606) for 300 units. The entity has a practical limitation on its ability to direct the equipment in its completed state because it could not do so without incurring a significant economic loss. The entity has an enforceable right to payment beginning when the contract is executed. Assume that each of the machines is distinct. At the inception of the contract, the entity has completed 50 units (that is, 50 units are in inventory awaiting shipment to the customer), has 10 units in production (that is, 10 units are in various stages of the manufacturing process), and has not begun manufacturing 240 units.
The staff concludes that at contract inception, the performance obligation to transfer 300 units meets the criteria for recognizing revenue over time because (1) the ice cream machines do not have an alternative use to the entity (i.e., because significant rework would be needed to redirect the assets to another customer) and (2) the entity has an enforceable right to payment for progress completed to date. Although the entity did not have an enforceable right to payment when it was customizing the ice cream machines in anticipation of a customer order, the criteria were met as soon as a valid and genuine contract existed. Consequently, the performance obligation to transfer 300 units to the customer is satisfied over time in accordance with ASC 606-10-25-27(c).

In the staff's example, the entity also meets the requirements in ASC 606-10-25-14 and 25-15 to account for the transfer of the 300 units as a series of distinct goods or services that constitute a single performance obligation. The entity would record (1) a cumulative catch-up adjustment to revenue to reflect its progress toward complete satisfaction of its performance obligation to transfer 300 units to its customer and (2) revenue for 50 completed and 10 in-process ice cream machines that will be transferred to the customer once the new contract is executed.

8.4.5.2.2 Impact of Intent and Past Practice on Enforceable Right to Payment

As discussed in 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.” This concept is further discussed in ASC 606-10-55-13, which states, in part:

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). [Emphasis added]

An entity may have an established practice of not enforcing its contractual or legal rights (e.g., not continuing to transfer the goods or services for which it could seek payment, not seeking a reimbursement in excess of cost, not collecting a penalty from the customer), or it may assert that it has no intention of enforcing its contractual or legal rights.

However, an entity generally should not consider its intent or past practice related to the enforcement of contractual or legal rights when performing an evaluation under ASC 606-10-25-29 to determine whether the enforceable right to payment criterion in ASC 606-10-25-27(c) is met. The determination of whether an enforceable right to payment exists is evaluated under the terms of the contractual arrangement as a matter of law. An entity's intent or past practice related to the enforcement of contractual or legal rights should be considered only if the intent or past practice has created a legal precedent as a matter of law that negates the enforceable right in a contract.

This is consistent with ASC 606-10-25-29, which states, in part:

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).
ASC 606-10-55-14 provides additional insight into the application of ASC 606-10-25-29. It states, in part, that the assessment of whether an entity has an enforceable right to payment should take into account 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.

The above issue is addressed in Implementation Q&A 56 (compiled from TRG Agenda Papers 56 and 60). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

**Connecting the Dots — Likelihood of Pursuing Payment**

ASC 606-10-25-29 provides that 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)” (emphasis added). In practice, it may be uncommon for an entity to pursue legal action against a customer if the customer canceled a contract, especially when there is an ongoing customer-vendor relationship. That is, entities may elect not to enforce their legal right to payment.

For example, suppose that Company A and Customer M have a long-standing relationship. Although A may have a legal right to recover its costs plus a reasonable profit margin if M terminates a contract, A and M may intend to negotiate a settlement to preserve the relationship in the event that a contract is terminated. Regardless of the likelihood that A would enforce its right to full payment from M, the criterion in ASC 606-10-25-27(c) is met as long as A has a legally enforceable right to payment that includes recovery of its costs plus a reasonable profit margin.

In addition to the above, entities should consider instances in which their past practice has rendered their right to payment unenforceable.

**8.4.5.2.3 Whether an Entity Has an Enforceable Right to Payment Upon Contract Termination When No Such Right Is Specified in the Contract**

Questions about the application of ASC 606-10-55-14(a) or (b) may arise when an entity creates a good with no alternative use and the written terms of the contract with the entity's customer do not specify the entity's right to payment upon contract termination. For example, this situation could occur in the United States, where the Uniform Commercial Code (UCC) or a state equivalent of the UCC is applied upon contract termination.

We believe that when a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment for performance completed to date is presumed not to exist.
However, if the contract with the customer does not specify by its written terms the entity's right to payment upon contract termination and the entity asserts that it has an enforceable right to payment for performance completed to date, we would expect the entity to:

- Support its assertion on the basis of legislation, administrative practice, or legal precedent that confers upon the entity a right to payment for performance to date, as stated in ASC 606-10-55-14(a). This analysis would need to demonstrate that an enforceable right to payment (as defined by ASC 606) exists in the relevant jurisdiction. The fact that the entity would have a basis for making a claim against the counterparty in a court of law would not be sufficient to support the existence of an enforceable right to payment.
- Assess whether relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect, as stated in ASC 606-10-55-14(b).

8.4.5.2.4 Impact of Shipping Terms on Revenue Recognition Over Time

Shipping terms in a contract that require a customer to pay only at a specific point in time (e.g., “free on board” (FOB) destination) do not preclude the contract from meeting the criterion in ASC 606-10-25-27(c) for revenue recognition over time (specifically, the enforceable right to payment condition).

The guidance in ASC 606-10-55-12 makes clear that an enforceable right to payment “need not be a present unconditional right to payment” and that an entity may have “an unconditional right to payment only . . . upon complete satisfaction of the performance obligation.” In these circumstances, the guidance states, “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” (emphasis added).

When a contract's shipping terms require an entity's customer to pay only at a specific point in time (e.g., FOB destination), the possibility that the entity will not be paid if the goods are lost in shipment would represent “the entity's failure to perform as promised” and should be disregarded in the entity's assessment of whether the performance obligation meets the criterion in ASC 606-10-25-27(c) for revenue recognition over time (i.e., when an entity is assessing whether it has an enforceable right to payment, it should presume that it will perform as promised and that the goods will be delivered). Accordingly, the conclusion that the entity has an enforceable right to payment is not precluded when the contract's payment terms require payment only at specific points in the production or delivery process. Those payment terms may be overruled by contractual rights that give the entity an enforceable right to demand or retain payment (if the entity performs as promised). Therefore, the fact that the customer would not be required to pay for the goods if they were lost in transit would not, by itself, preclude the contract from meeting the criterion in ASC 606-10-25-27(c) for revenue recognition over time.
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.

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.” (See Section 8.5.8.)

- **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.” (See Section 8.5.9.)

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.

The above statement from paragraph BC164 of ASU 2014-09 does not mean that it is preferable for an entity to use an output method when measuring progress toward complete satisfaction of a performance obligation. 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 BC165 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.)

8.5.2 Whether Control of a Good or Service Can Be Transferred at Discrete Points in Time When the Underlying Performance Obligation Is Satisfied 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., milestones³] rarely would be permissible.”⁴

The FASB staff believes (as discussed in Implementation Q&A 51) that View B is inconsistent with the new revenue standard but that View A is appropriate. The staff reiterates 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 indicates that in accordance with paragraph BC135 of ASU 2014-09, 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).”⁵

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³ 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 legacy U.S. GAAP.

⁴ Quoted from paragraph 19 of TRG Agenda Paper 53.

⁵ Quoted from Implementation Q&A 51.
The FASB staff also notes 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.

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.

Because control of the related good or service cannot be transferred at discrete points in time if a performance obligation meets one of the criteria in ASC 606-10-25-27, the measure of progress selected for such a performance obligation should be consistent with the pattern of transfer of control of the good or service over time and should not result in the recognition of work in progress (or a similar asset) as the entity performs work between discrete points of revenue recognition (see Example 13-2).

ASC 606-10-25-27 does not, however, require an entity's performance over time to be continuous and uninterrupted. Accordingly, a gap in the entity's performance (e.g., if the entity does not perform any activities toward satisfying the performance obligation in a particular financial reporting period) does not in itself prevent the entity from recognizing revenue over time. In addition, as discussed in Section 13.3.3.2, it will typically be appropriate for the entity to continue to recognize any incurred contract-fulfillment costs related to future performance as assets, such as inventories and other assets that have not yet been used in the contract and are still controlled by the entity.

The above issues are addressed in Implementation Q&A 51 (compiled from previously issued TRG Agenda Papers 53 and 55). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

8.5.3 Use of a Multiple Attribution Approach (as Compared With a Single Method for Measuring Progress)

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.

The FASB staff notes that while there is diversity in practice under legacy 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.” Accordingly, the staff concludes that an entity should use a single measure of progress for each performance obligation identified in the contract.

In addition, the FASB staff observes 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, although it emphasizes that the selection is not a free choice. Further, the staff notes 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. However, a reexamination may suggest that the contract includes more performance obligations than were initially identified.

The above issues are addressed in Implementation Q&As 47 and 48 (compiled from previously issued TRG Agenda Papers 41 and 44). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

8.5.4 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

In some circumstances, an entity will need to identify 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). Further, 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 complete satisfaction of that performance obligation.” For measuring both performance completed to date under ASC 606-10-25-27(c) (to determine whether

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6 Quoted from Implementation Q&A 47.
revenue should be recognized over time) 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 8-5**

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 606-10-25-27(c).

**8.5.5 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.
8.5.6 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 common for estimates related to an entity’s level of progress to 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, but there could be a cumulative-effect adjustment to revenue in the current period). 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.

8.5.7 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 discussed in Section 8.5.1, the new revenue standard requires an entity to select the method that faithfully 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 legacy U.S. GAAP (ASC 605-35, formerly SOP 81-1) and IFRS Standards (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, in certain circumstances under legacy 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 13 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).

Example 8-6 below illustrates a situation in which progress toward complete satisfaction of a performance obligation cannot be reasonably measured.

Example 8-6

A contractor enters into a building contract with fixed consideration of $1,000. 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.
8.5.8 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 should be an objective measure of the entity's performance (i.e., the measure is directly observable, and information needed to apply the measure is readily available).

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.

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. However, a drawback of using an output method is that there may not always be a directly observable or objectively determined output to reliably measure an entity's progress, and it could fail to measure progress between directly observable or objectively determined outputs. 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 faithful 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.

8.5.8.1 Practical Expedient for Measuring Progress

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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<tbody>
<tr>
<td>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.</td>
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</table>

The new revenue standard provides a practical expedient in ASC 606-10-55-18 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).

8.5.8.1.1 Using the Invoice Practical Expedient When the Unit Price or Rate Varies During the Contract Period

The option to apply the invoice practical expedient in ASC 606-10-55-18 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).”

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 FASB staff has noted that an entity must use judgment and that conclusions are likely to vary depending on the facts and circumstances. The staff believes 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 if the contracts’ respective price and rate changes reflect the “value to the customer of each incremental good or service that the entity transfers to the customer.”

7 Quoted from ASC 606-10-55-18.
8 Quoted from paragraph BC167 of ASU 2014-09.
Connecting the Dots — Electricity Supply Agreements

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.

In this example, 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 above issue is addressed in Implementation Q&A 46 (compiled from previously issued TRG Agenda Papers 40 and 44). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

8.5.8.1.2 Applying the Invoice Practical Expedient to Contracts With Up-Front Consideration or Back-End Fees

An entity is not necessarily precluded from applying the invoice practical expedient in ASC 606-10-55-18 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 above issue is addressed in Implementation Q&A 46 (compiled from previously issued TRG Agenda Papers 40 and 44). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

8.5.9 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.
A common input method is the "cost-to-cost" method, as implied by the use of the term "costs incurred" in ASC 606-10-55-20 as an example of a basis for measuring progress. When applying the cost-to-cost method, an entity uses costs incurred as compared with total estimated costs. Types of costs that an entity may consider when applying the cost-to-cost method include direct labor, direct materials, subcontractor costs, and other costs incurred that are related to the entity’s performance under a contract. In addition, while certain overhead costs may be appropriate for consideration under the cost-to-cost method, an entity should use judgment to include only allocated costs (in measuring progress) that actually contribute to the transfer of control to the customer of the performance obligation(s). For example, it would generally not be appropriate for an entity to include general and administrative costs or sales and marketing costs in measuring the progress toward satisfying a performance obligation unless (1) those costs are directly chargeable to the customer and (2) including such costs faithfully depicts the entity’s progress toward satisfying the performance obligation. In making this distinction, entities may refer to ASC 340-40-25-7, which includes types of costs that are directly related to a contract.

### 8.5.9.1 Inefficiencies and Wasted Materials

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<th>ASC 606-10</th>
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</table>
| **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).

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.
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.

ASC 606 contains specific guidance on accounting for costs of fulfilling 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.”

8.5.9.2 Uninstalled Materials

<table>
<thead>
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<th>ASC 606-10</th>
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<tbody>
<tr>
<td>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: . . .</td>
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<tr>
<td>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:</td>
</tr>
<tr>
<td>1. The good is not distinct.</td>
</tr>
<tr>
<td>2. The customer is expected to obtain control of the good significantly before receiving services related to the good.</td>
</tr>
<tr>
<td>3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.</td>
</tr>
<tr>
<td>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).</td>
</tr>
</tbody>
</table>
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 the 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.
Chapter 8 — Step 5: Determine When to Recognize Revenue

ASC 606-10 (continued)

55-188 A summary of the transaction price and expected costs is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction price</td>
<td>$ 5,000,000</td>
</tr>
<tr>
<td>Elevators</td>
<td>$ 1,500,000</td>
</tr>
<tr>
<td>Other costs</td>
<td>$ 2,500,000</td>
</tr>
<tr>
<td>Total expected costs</td>
<td>$ 4,000,000</td>
</tr>
</tbody>
</table>

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).

55-192 Consequently, at December 31, 20X2, the entity recognizes the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$ 2,200,000 (a)</td>
</tr>
<tr>
<td>Costs of goods sold</td>
<td>$ 2,000,000 (b)</td>
</tr>
<tr>
<td>Profit</td>
<td>$ 200,000</td>
</tr>
</tbody>
</table>

(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.
Example 8-7 illustrates the treatment of prepaid costs for work to be performed in the future.

### Example 8-7

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 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. To calculate the progress toward complete satisfaction of its performance obligation, the contractor uses an input method based on costs incurred to date in proportion to the total anticipated contract costs.

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 may 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.

<table>
<thead>
<tr>
<th>Cost incurred to date</th>
<th>$300</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: materials purchased for later years</td>
<td>$(50)</td>
</tr>
<tr>
<td>Costs incurred for work performed to date</td>
<td>$250</td>
</tr>
<tr>
<td>Total estimated costs</td>
<td>$900</td>
</tr>
<tr>
<td>Percentage completion at end of year 1</td>
<td>28%</td>
</tr>
</tbody>
</table>

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 8.5.5.

### 8.5.9.3 Incremental Costs of Obtaining a Contract

When using an input method, an entity should exclude from its measure of progress the costs it incurred to obtain the contract with the customer because such costs do not depict an entity’s performance under the contract. Chapter 13 discusses how to account for the incremental costs of obtaining a contract with a 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 from the measurement of progress (both the measure of progress to date and the estimate of total costs incurred 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 is related (see Chapter 13 for additional information). 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. In contrast, costs of fulfilling the contract that depict an entity’s performance would be included in the measurement of progress.

### 8.5.10 Measuring Progress — Stand-Ready Obligations

As discussed in Section 5.4.3, 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**

<table>
<thead>
<tr>
<th>Example 18 — Measuring Progress When Making Goods or Services Available</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-184</strong> 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.</td>
</tr>
<tr>
<td><strong>55-185</strong> 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).</td>
</tr>
<tr>
<td><strong>55-186</strong> 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.</td>
</tr>
</tbody>
</table>

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 input and output methods. 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 (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.

- **Unspecified 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 determination of an appropriate measure of progress for a stand-ready obligation is addressed in Implementation Q&A 49 (compiled from previously issued TRG Agenda Papers 16 and 25). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

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. For example, an entity may sell products through a third-party distributor and implicitly or explicitly promise to provide a stand-ready service to the end customer. In these situations, the entity should begin to recognize revenue for a stand-ready service promised to a customer's customer when the end customer has the ability to access, and begin to consume and benefit from, the service. In addition, as illustrated in Examples 8-8 and 8-9, 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 (i.e., 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.

In Examples 8-8 and 8-9 below, Entity X enters into two different contracts, one with Customer A and the other with Customer B, to provide cloud computing capacity. Because of the nature of X's business, very little incremental effort is required as X's customers use the cloud computing capacity.

**Example 8-8**

**Contract With Customer A for a 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 throughout the contract term but expects A to use all of the agreed capacity before the end of the contract. Once A has used the specified quantity of capacity, A no longer has the ability to use the service, and additional capacity must be separately negotiated.

As discussed in Section 5.4.3.2, 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 Section 5.4.3.2), when A uses cloud computing capacity, A's usage does affect the amount of the remaining services to which A 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 8-9**

**Contract With Customer B for an 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).

**Connecting the Dots — Nature of Promise to Provide Software as a Service**

In some arrangements — specifically, arrangements involving software as a service (SaaS) — it may not always be clear whether the nature of the promise is (1) an obligation to provide a specified amount of services (e.g., 5,000 transactions processed through software provided as a service) or (2) a stand-ready obligation to provide services when and if called upon (e.g., to process all of the transactions required through SaaS). Sometimes in practice, an entity may price a SaaS arrangement on the basis of volume expectations but may still be required to stand ready to provide the service for the entire contractual period regardless of whether the customer exceeds the volumes expected at contract inception. In other cases, a customer's
right to use the service may terminate once the initial volumes are exceeded, or the contract would be modified once the volumes are exceeded. In all of these circumstances, an entity will need to carefully consider the contractual rights and obligations to appropriately identify the nature of the promise and to determine an appropriate measure of progress toward complete satisfaction of the performance obligation.

8.6 Revenue Recognized at a Point in Time

- Does the customer simultaneously receive and consume the benefit as the entity performs?
  - Yes
  - No

- Does the entity’s performance create or enhance a customer-controlled asset?
  - Yes
  - No

- Does the performance obligation is satisfied over time. Refer to Sections 8.4 and 8.5.
  - No

- Does the entity’s performance create an asset with an alternative use?
  - Yes
  - No

- Does the entity have an enforceable right to payment for performance completed to date?
  - Yes
  - No
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 been 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. In addition, 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.

8.6.1 Impact of Governing Laws on the Determination of When the Control of Goods Is Transferred to a Customer

Typically, an entity would recognize revenue for the sale of goods at the point in time when control is transferred to the customer. As discussed in Section 8.3.1, 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. As a result, it is possible that the timing of revenue recognition could differ for the sale of the same good in different jurisdictions. The following are examples of the impact of 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, legal title, which is an indicator of the transfer of control in ASC 606-10-25-30, does not 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.
8.6.2 Timing of Revenue Recognition When a Right of Return Exists

Example 8-10 below illustrates the timing of revenue recognition when goods are sold to a distributor with a right of return and the distributor subsequently resells the goods to a retailer.

**Example 8-10**

Company LH is a manufacturer of specialized products that are each embedded with an activation chip. The products are sold through a distribution chain before ultimately being sold to the end customer. Company LH initially sells its products to Distributor D, an unrelated party that is LH’s customer. Title to and physical possession of the products are transferred to D upon delivery to its warehouse. In addition, D has the right to pledge any products within its possession as collateral. Once the products are delivered to D, LH no longer has the right to redirect the products (i.e., LH cannot require D to return the products so that LH can sell the products to another party).

Distributor D then separately negotiates with Retailer R to resell the products. Title to and physical possession of the products are transferred to R upon delivery of the products to R's location. Upon receipt of the products, R activates the chip embedded in each of them. Once the chip embedded in a product is activated, R is able to sell the product to an end user.

Before activation, all parties in the distribution chain (i.e., R and D) have a general right of return related to the products. Once R activates the chip embedded in each product, the products may no longer be returned to LH. That is, LH retains some of the inventory risk (i.e., back-end inventory risk upon product returns) associated with the products until activation occurs. In addition, LH has only a right to payment for the products once the products are activated.

There are no specific acceptance terms in LH’s contracts to sell the products.

On the basis of the facts and circumstances, LH should **not** defer revenue recognition until the products are sold to and activated by R (i.e., recognize revenue on a sell-through basis). Rather, LH should recognize revenue when it transfers control of the products to its customer (i.e., D). As stated in ASC 606-10-25-25, “[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. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.”

To help an entity determine whether control of an asset has been transferred to a customer, ASC 606-10-25-30 provides the following indicators:

- **Present right to payment** — As noted above, LH does not have a right to payment for the products until R activates the chip embedded in each of them. This may indicate that control of the products is not transferred until the products are sold to R and the chip is activated.
- **Legal title** — Legal title of the products is transferred from LH to D upon delivery of the products to D's warehouse. Although R does not obtain legal title to the products until it obtains physical possession, this indicator focuses on when the entity's customer obtains legal title. In the example, LH’s customer is D. Therefore, when LH evaluates this indicator, it should focus on when D obtains legal title (i.e., when LH relinquishes legal title to the products). This indicates that control of the products is transferred before the sale to and activation by R — specifically, when the products are delivered to D's warehouse.
- **Physical possession** — Physical possession of the products is transferred to D upon delivery of the products to D's warehouse, which occurs before the products are sold to R. Further, in accordance with ASC 606-10-55-79 and 55-80, LH has determined that the sale of the products does not represent a consignment arrangement.
- **Significant risks and rewards of ownership** — As discussed above, LH retains some of the inventory risk (i.e., back-end inventory risk related to product returns) associated with the products until R activates the chip embedded in each product. This is because D and R have a general right of return related to the products before activation. However, once the products are in D's warehouse, LH no longer has the ability to redirect the products. Rather, D has the ability to sell the products to its own customers and the right to pledge any products within its possession as collateral. Therefore, most of the risks and rewards of ownership are transferred to D, but others are retained by LH.
Example 8-10 (continued)

- **Customer acceptance** — As noted above, there are no specific acceptance terms in LH's contracts to sell the products. However, D is deemed to have accepted the products upon delivery to D's warehouse because this is the point in time at which title to and physical possession of the products are transferred to D.

Although LH retains certain risks associated with the products and is not entitled to payment until R activates the products, control of the products is transferred upon sale to D because this is the point in time at which LH no longer has the right to direct the use of the products and D obtains the right to direct the use of the products. In addition, LH does not have the ability to prevent D from directing the use of the products (i.e., by reselling the products to R). Company LH's transfer of control is also supported by the fact that legal title to the products is transferred to D, which is one of the indicators of control in ASC 606-10-25-30. Further, D has the right to obtain substantially all of the benefits from the products not only through its ability to sell the products to R (or any other customer) but also through its ability to pledge the products as collateral. For these reasons, control of the products is transferred upon delivery of the products to D. Therefore, it would be inappropriate for LH to defer revenue recognition until the products are sold to and activated by R. However, LH should estimate the number of products that it expects will be returned to determine its transaction price in accordance with ASC 606-10-55-22 and 55-23.

### 8.6.3 Present Right to Payment for the Asset

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-30</strong></td>
</tr>
<tr>
<td>a.</td>
</tr>
</tbody>
</table>

The first indicator that control has been 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 been 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 been transferred to the customer and that the entity can recognize revenue.

### 8.6.4 Legal Title to the Asset

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-30</strong></td>
</tr>
<tr>
<td>b.</td>
</tr>
</tbody>
</table>
The second indicator that control has been 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 legacy U.S. GAAP, the transfer of control typically coincides with the transfer of legal title. As illustrated in Section 8.6.4.1 below, there may be limited instances in which the entity retains legal title to the asset but is not precluded from recognizing revenue.

### 8.6.4.1 Retention of Title to Enforce Payment (Uniform Commercial Code)

In certain sales transactions, a seller may retain legal title to an asset after transferring physical possession of that asset to its customer. In some countries, it is common for a seller to retain a form of title until the customer makes payment so that the seller can recover the goods in the event of customer default on payment. In these instances, the seller’s retention of title does not affect the customer’s ability to direct the use of, or obtain substantially all of the remaining benefits from, the goods. Accordingly, it is appropriate in these circumstances for the seller to recognize revenue when the goods are delivered.

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.

In the circumstances described, control of the goods has been transferred from the seller to the customer even though title has not. Transfer of title may indicate that control of the asset has been 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 would not preclude the customer from obtaining control of an asset.” Consequently, as long as other indicators demonstrate that control of the asset has been transferred to the customer, revenue should be recognized.

This may be the case even in the United States, where sales and other commercial transactions are subject to the Uniform Commercial Code (UCC). Under the UCC, the retention of legal title results in the seller’s retention of rights normally held by an owner of goods (such as the legal right to directly dispose of the goods and the right to prohibit the moving, selling, or other use of the goods). An entity must carefully evaluate the control indicators and the overall control principle in these circumstances to determine when control of a good is transferred to a customer.
The example below illustrates this concept.

**Example 8-11**

Company A is a global mining company whose products — primarily iron ore pellets — are used in the integrated steel industry. Company A’s contracts with its customers include a provision under which title to, and the risk of loss, damage, or destruction of, iron ore pellets are not transferred to the customer until receipt of payment. This clause is intended to be protective, and its main objective is to provide additional protection to A in the event of nonpayment. (For purposes of this example, assume that collectibility is not in question.) Under these arrangements, which are governed by the UCC, A will ship the iron ore pellets to the customer’s facility before receiving payment. Upon delivery of the iron ore pellets to the customer’s facility, A has a present right to payment (i.e., the customer cannot refuse or withhold payment for iron ore pellets that have been delivered). Because of the nature of the products (tons of iron ore), once the iron ore pellets have been delivered to the customer’s facility, it is not practical to physically redirect them to another location, and physical risk of loss is not substantive since the pellets are virtually indestructible. Once delivered, the pellets are indistinguishable from pellets at the customer’s location for which title has been transferred (i.e., payment has been made). In addition, the contract does not prohibit the customer from consuming the pellets before payment. That is, the customer can direct the use of, and obtain the benefits from, the pellets once the pellets are delivered to the customer’s location.

The table below provides an assessment of indicators that control has been transferred to the customer.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Upon Delivery</th>
<th>Upon Receipt of Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present right to payment</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Legal title</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Physical possession</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Risks and rewards of ownership</td>
<td>X (rewards of ownership)</td>
<td>X (risk of loss)</td>
</tr>
<tr>
<td>Customer acceptance</td>
<td></td>
<td>N/A (perfunctory)</td>
</tr>
</tbody>
</table>

Notwithstanding that A retains legal title, it is appropriate for A to recognize revenue upon delivery of the iron ore pellets. In light of the assessment of the control indicators in the table above and an assessment of the control principle, control of the iron ore pellets is transferred from the seller to the customer upon delivery even though title is not transferred until payment is received. Given the nature of the product, greater emphasis should be placed on the physical possession and right to payment indicators because while A may retain the right to redirect or repossess the goods in the event that the customer does not pay, A does not have the practical ability to do so. In addition, the risk of loss is not meaningful in this scenario since the product is virtually indestructible. Further, the contract does not prohibit the customer from consuming the goods before payment, and because of the pellets’ physical location (i.e., at the customer’s location), the customer has the ability to use the pellets in its own production facilities. Therefore, from the customer’s perspective, the customer controls the iron ore pellets once the pellets are delivered to the customer’s location.

**8.6.4.2 Evaluating Whether Control Has Been Transferred in a Sale of Real Estate Without a Formal Closing**

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 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. Recognition of revenue (or gains or losses on sales to noncustomers) would be inappropriate in this case if collectibility is not probable.

8.6.5 Transfer of Physical Possession of the Asset

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
</table>

25-30 An entity shall consider indicators of the transfer of control, which include, but are not limited to, the following: . . .

c. The entity has transferred physical possession of the asset — The customer’s physical possession of an asset may indicate that the customer has obtained control of the asset. However, physical possession may not coincide with control of an asset. For example, in some contracts for deed and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some buy-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.

The third indicator that control has been 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 8.7, 8.6.8, and 8.6.9 for further discussion of repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

Connecting the Dots — Recognition of Revenue From the Sale of Goods With Resale Restrictions

Sometimes, an entity (e.g., a manufacturer) may sell goods to a reseller (e.g., distributor or retailer) that then resells the goods to end customers (e.g., consumers). In situations in which the reseller is the entity's customer, the entity should recognize revenue when control of the goods is transferred to the reseller. However, in certain cases, the reseller may be restricted in its ability to resell the goods. Common examples include (1) seller-imposed restrictions (e.g., the entity contractually precludes the reseller from reselling the goods until a certain date or other event occurs) and (2) restrictions inherent in the goods (e.g., seasonal or other time-based restrictions not imposed by the seller).
When a reseller is restricted in its ability to resell a good purchased from an entity, the entity should consider the nature of the restriction when determining whether control of the good has been transferred to the reseller (i.e., the entity’s customer). Seller-imposed restrictions that affect the reseller’s ability to direct the use of and obtain substantially all of the remaining benefits from the good would suggest that control of the good has not been transferred to the reseller.

For example, if a seller transfers physical custody of a good to a reseller but does not permit the reseller to sell that good to a third party until some future date, and the underlying good does not have any benefit to the reseller other than through the resale of the good, it is likely that control of the good has not been transferred. That is, the reseller cannot direct the use of or obtain substantially all of the remaining benefits from the good. In such a case, the entity should not recognize revenue until the seller-imposed restriction lapses.

However, if the restriction is inherent in the good rather than imposed by the seller, the reseller may have obtained control of the good (since the restriction would be inherent in how and when the benefits of controlling the good are derived).

**Example 8-12**

Entity P, a publisher, ships copies of a new book to Entity R, a retailer. Entity P’s terms of sale restrict R’s right to resell copies of the book to its customers (i.e., end customers and other resellers) for several weeks to ensure a consistent release date across all retailers. Further, P has the right and ability to either shorten or extend the amount of time before R can resell copies of the book up to the release date. Entity P is required to recognize revenue when, after considering the indicators of control in ASC 606-10-25-30, it determines that control of the goods has been transferred to R.

Entity P should not recognize revenue until the time-based restriction lapses and R can resell copies of the book. Although R has physical possession of the copies, it does not have the ability to direct the use of and receive all of the remaining benefits from the copies since it is unable to resell them before the release date. Therefore, control of the copies has not been transferred to R.

**Example 8-13**

On January 1, Entity L, a clothing manufacturer, ships shorts and swimwear to Entity C, a retailer. Entity L does not explicitly restrict C from reselling the clothing until a certain date (i.e., there are no seller-imposed restrictions on the resale of the clothing). However, C decides not to make the clothing available for resale until March 1 because it has determined on the basis of its experience that consumers do not buy shorts and swimwear for the upcoming summer until March. Entity C believes that it would be more beneficial to continue to display jeans and sweaters during January and February.

Although C is restricted in its ability to resell the clothing until March 1, this restriction is due to the seasonal nature of the clothing, which is a restriction that is inherent in the good. Entity L concludes that control of the clothing is transferred to C on January 1. Therefore, L should recognize revenue from the sale of the clothing to C on January 1.
8.6.6 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: . . .

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. . . .

The fourth indicator that control has been 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 been 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 been 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.

8.6.7 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: . . .

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 been 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.
ASC 606-10 (continued)

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.

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 been 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 been transferred to the customer.
The decision tree below illustrates the considerations relevant to customer acceptance provisions.

1. **Does the customer effectively have a trial period before it is committed to pay?**
   - **Yes**: Wait for trial period to lapse or formal acceptance to occur.
   - **No**: Proceed to next step.

2. **Is customer acceptance based on subjective evaluation or objective criteria?**
   - **Subjective**: Depending on the facts and circumstances, either revenue should not be recognized until acceptance occurs or the customer acceptance should be treated as a right of return.
   - **Objective**: Proceed to next step.

3. **Are the criteria standard for the asset or unique to the contract?**
   - **Standard**: Proceed to next step.
   - **Unique**: Proceed to next step.

4. **Has the ability to meet the criteria been demonstrated?**
   - **Yes**: The acceptance provisions should be evaluated as a warranty (i.e., assurance-type or service-type warranty).
   - **No**: Proceed to next step.

5. **Has compliance with specifications in an environment similar to the customer’s been demonstrated?**
   - **Yes**: The acceptance provisions do not prohibit a conclusion that control has transferred.
   - **No**: Revenue should not be recognized until acceptance occurs or compliance is demonstrated.

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The decision tree provides a structured approach to determine when to recognize revenue based on various criteria related to customer acceptance provisions.
8.6.8 Consignment Arrangements

Although physical possession is an indicator that control has been 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.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-79</strong> 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.</td>
</tr>
<tr>
<td><strong>55-80</strong> Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).</td>
</tr>
<tr>
<td>c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).</td>
</tr>
</tbody>
</table>

Under ASC 606, the accounting for consignment arrangements is consistent with legacy U.S. GAAP in that products delivered to a consignee in accordance with a consignment arrangement generally are not sales and do not qualify for revenue recognition until the consignee sells the products to a third party, at which point control of the products is transferred from the consignor to the third party. It is not uncommon for the consignee to obtain flash title before title is transferred to the third party.

8.6.9 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. Customers may request that arrangements be designed this way to meet certain needs. For example, a customer may have limited storage capacity or may not be able to immediately use the goods. Under such circumstances, the customer may request that the vendor hold the goods for some period, but the customer is nonetheless committed to purchase the goods.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-81</strong> 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.</td>
</tr>
</tbody>
</table>
Chapter 8 — Step 5: Determine When to Recognize Revenue

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 the 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.

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.
ASC 606-10 (continued)

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.

Changing Lanes — 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. However, in August 2017, the SEC released SAB 116, which conforms existing SEC guidance with ASC 606. With the release of SAB 116, SAB Topic 13 is no longer applicable upon an SEC registrant’s adoption of ASC 606.

SAB Topic 13 provided the SEC staff's views on general revenue recognition guidance as codified in legacy U.S. GAAP. SAB 116 notes that ASC 606 “provides a single set of revenue recognition principles governing all contracts with customers and supersedes the existing revenue recognition framework in [legacy U.S. GAAP], which eliminates the need for [SAB] Topic 13.” SAB 116 also states that upon adoption of ASC 606, “a registrant should no longer look to the guidance in Securities Exchange Act Release No. 23507 and Accounting and Auditing Enforcement Release No. 108 . . . for criteria to be met in order to recognize revenue” on a bill-and-hold basis. Such legacy guidance is also included in SAB Topic 13.

The bill-and-hold guidance in SAB Topic 13 (which is still applicable until the adoption of ASC 606) is more detailed than the bill-and-hold guidance in ASC 606. The most noticeable distinction is that SAB Topic 13 requires bill-and-hold arrangements to include a fixed delivery schedule, whereas ASC 606 does not include this requirement.

Example 8-14 below illustrates how to determine whether it is appropriate to recognize revenue from the sale of a product in a bill-and-hold arrangement.

Example 8-14

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. While the product is in storage, A has risk of loss or damage to the product. In addition, A retains legal title to the product, and payment by the customer depends on delivery to a customer-specified site.

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 (text quoted from ASC 606-10-25-30):

- “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, even if the entity meets the bill-and-hold criteria in ASC 606-10-55-83, the customer does not control the product, and revenue cannot be recognized.
8.6.10 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.

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 typically also affect when the risks and rewards of ownership are transferred 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.

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.

8.6.10.1 Impact of Unspecified Shipping Terms

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 been 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.

8.6.10.2 Goods Shipped FOB Destination but Shipping Company Assumes Risk of Loss

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.

Example 8-15 below illustrates how to determine whether it is appropriate to recognize revenue when goods are shipped FOB destination but a third-party shipping company assumes the risk of loss.
Example 8-15

Company A, which sells goods 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.

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. Therefore, it is not appropriate for A to recognize revenue when the goods are shipped.

8.6.10.3 “Synthetic FOB Destination” Shipping Terms

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.

In evaluating arrangements with synthetic FOB destination shipping terms, 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 606-10-25-30, 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. The seller would be required to use judgment in applying the guidance 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 (under the assumption 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 in such a way 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 606-10-25-30. 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) even if the seller retains some of the risks of the shipped goods.

**Connecting the Dots — FOB Synthetic Destination**

It is important to understand the shipping terms of an arrangement to determine when control of the good is transferred 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 legacy U.S. GAAP is critical to the assessment of transfer of control.

Legacy 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 legacy 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 be transferred 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 is transferred 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 5.2.4.3 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 been 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 been 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 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.

Pending Content (Transition Guidance: ASC 842-10-65-1)

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 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 and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with 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.

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:

<table>
<thead>
<tr>
<th><strong>ASC 606-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 62 — Repurchase Agreements</strong></td>
</tr>
<tr>
<td><strong>55-401</strong> An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.</td>
</tr>
<tr>
<td><strong>Case A — Call Option: Financing</strong></td>
</tr>
<tr>
<td><strong>55-402</strong> 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.</td>
</tr>
<tr>
<td><strong>55-403</strong> 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.</td>
</tr>
<tr>
<td><strong>55-404</strong> On January 1, 20X7, the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.</td>
</tr>
</tbody>
</table>

### 8.7.1.1 Contingent Repurchase Agreements

ASC 606-10-55-68 states that “[i]f 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.” In some situations, an entity may exercise its call option (i.e., repurchase the asset) only upon the occurrence of a future event (e.g., termination of the contract).
The presence of a right to repurchase an asset typically precludes an entity's customer from obtaining control of that asset and therefore typically precludes the entity from recognizing revenue from the sale of that asset. This conclusion is based on the notion that the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Therefore, it is important for the entity to consider whether the contingency related to the call option limits the customer’s ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Specifically, when determining whether the contingent call option affects the customer’s ability to control the asset, the entity should consider whether the triggering of the contingency is within the entity’s or the customer’s control.

Repurchase options that are contingent on factors within the entity’s control would generally imply that the customer has not obtained control of the asset. In such cases, the entity should account for the contract as a lease or financing arrangement in a manner consistent with the guidance in ASC 606-10-55-68. Alternatively, repurchase options that are contingent on factors within the customer’s control may imply that the customer has the ability to determine whether the call option may be exercised. For example, if an entity can repurchase an asset sold to a customer only in the event that the customer terminates the contract for convenience (i.e., the entity does not have a right to terminate the contract), the triggering of the call option is within the customer’s control. In that situation, the entity may reasonably conclude that the customer obtains control of the asset even though there is a contingent call option.

8.7.1.2 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.

A call option or forward that is dependent on the passing of an expiration date (such as the one discussed above) does not require a transaction to be accounted for as a lease or financing, in accordance with ASC 606-10-55-68. 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.
8.7.1.3 Sale of a Commodity That Is Subject to an Agreement to Repurchase the Commodity at Its Prevailing Market Price on the Date of Repurchase

ASC 606-10-55-68 provides that when an entity sells an asset to a customer but has an obligation or a right to repurchase the asset (a forward or a call option), the 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 (1) a lease in accordance with ASC 840 or ASC 842, as applicable (if the repurchase price of the forward or call option is less than the original selling price) or (2) a financing arrangement in accordance with ASC 606-10-55-70 (if the exercise price of the forward or call option is equal to or greater than the original selling price). The accounting treatment of a repurchase at market price (which could be greater than, less than, or equal to the original selling price) is not specifically addressed.

If an entity sells a quantity of a commodity to a customer but has an obligation or a right to repurchase an equivalent amount of that commodity (i.e., an asset that is substantially the same as that originally sold) at the prevailing market price for that commodity, the entity is not always precluded from recognizing a sale for the original commodity.

Although ASC 606-10-55-68 precludes an entity from recognizing revenue when a contract includes a forward or call option, this guidance is based on the notion that control of the asset has not passed to the entity’s 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.” Similarly, paragraph BC424 of ASU 2014-09 notes that the FASB’s and IASB’s rationale for concluding that no revenue should be recognized when an entity holds a forward or call option to repurchase an asset is that the entity’s customer does not obtain control of the asset.

As acknowledged in paragraph BC425 of ASU 2014-09, in circumstances in which a substantially similar asset is readily available in the marketplace (which may be the case for a commodity), an entity’s agreement with a customer to repurchase an asset at the asset’s prevailing market price on the date of repurchase may not constrain the customer’s ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset originally sold. Accordingly, it is important to consider whether an entity’s obligation or right to repurchase a substantially similar commodity does, in fact, limit the ability of the entity’s customer to control the commodity originally sold. This will depend on a careful analysis of the specific facts and circumstances.

If the entity’s customer is in any way limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset originally sold, the entity should not account for the contract as a sale but instead should account for the contract in accordance with the contract’s nature (e.g., as a lease or financing arrangement). In addition, the entity should consider whether the contract includes any other element, such as payment for transport of the commodity, which should be accounted for separately.

However, if there is sufficient evidence to demonstrate that the entity’s customer is not limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset (and, therefore, that control of the asset has clearly been transferred to the customer), the entity should account for the contract as a sale in accordance with ASC 606. For this to be possible, it would be necessary that (1) the customer could readily source the equivalent commodities and the requisite quantities at the appropriate time and in the appropriate location to satisfy the requirements of the forward or call option and (2) the repurchase price to be paid is equivalent to the prevailing market price on the date of repurchase.
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 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.

Pending Content (Transition Guidance: ASC 842-10-65-1)

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 842 on leases unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with 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 graphic illustrates the application of this guidance to transactions involving a put option held by the customer:

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 omitted⁹]

**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.

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⁹ Case A of Example 62, on which Case B is based, is reproduced in Section 8.7.1.
ASC 606-10 (continued)

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.

Pending Content (Transition Guidance: ASC 842-10-65-1)

55-407 In accordance with paragraphs 606-20-55-72 through 55-73, the entity accounts for the transaction as a lease in accordance with Topic 842 on leases.

8.7.2.1 Accounting for Trade-In Rights

In certain contracts with customers, an entity may agree to provide its customer with the right to trade in the original specified good for a fixed price if the customer purchases the next version of the specified good once it becomes available (the "trade-in right").

To account for a trade-in right in its contract with a customer, an entity will need to evaluate the specific terms of the arrangement and determine whether the trade-in right is within the scope of ASC 460. If the entity concludes that the trade-in right is outside the scope of ASC 460, it should apply the guidance in ASC 606 to the entire arrangement.

If the entity concludes that the trade-in right is within the scope of ASC 460, the fixed-price trade-in right should be measured at fair value and excluded from the transaction price. The remaining transaction price should then be allocated to the remaining elements within the scope of ASC 606 (i.e., the product) and recognized when control of the product is transferred to the customer (e.g., upon delivery).

If the trade-in right is outside the scope of ASC 460, the fixed-price trade-in right should be assessed under the repurchase guidance in ASC 606. The trade-in right is a put option since the entity is obligated to repurchase the product at the customer's option. If the repurchase price is less than the original selling price, the entity must evaluate whether the customer has significant economic incentive to exercise the right. If the entity determines that the customer has significant economic incentive to exercise the right, it would account for the arrangement as a lease. If the entity determines that the customer does not have a significant economic incentive to exercise the right, it may be appropriate to account for the element as a sale with a right of return. However, the facts and circumstances of the trade-in right should be evaluated, and other accounting models may be appropriate.

8.7.3 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 legacy 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. However, in arrangements involving residual value guarantees, an entity should bifurcate and account for the residual value guarantee at fair value under ASC 460 while accounting for the remaining contract consideration under ASC 606.

ASC 840-10-55-14A, which was added by ASU 2014-09, clarifies that arrangements involving residual value guarantees do not represent repurchase agreements and should be accounted for under ASC 460 and ASC 606. Specifically, ASC 840-10-55-14A states 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.”

### 8.7.4 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 customer if the customer subsequently plans to accept a bona fide offer from a third party to purchase the asset from the customer. 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 customer received from the third party. Such terms are commonly referred to as a “right of first refusal.”

ASC 606-10-55-68 states, in part, that “[i]f 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.” However, 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.

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**Example 8-16**

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 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 11) and the allocation guidance in step 4 (see Chapter 7 for further discussion). In light of this, the sections below take a deeper dive into the application of the new implementation guidance on breakage.

**8.8.1 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. Typically, they 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.”

For an entity to determine whether it expects to be entitled to a breakage amount, the 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.
8.8.2 Changes in Expectation of Breakage After Initial Allocation of Revenue

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 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 amount allocated to the expected breakage to be amended. However, the expected breakage could affect the timing of recognition of revenue 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.”

Example 8-17 below illustrates how changes in expected breakage could affect the timing of revenue recognition.

Example 8-17

Entity M sells a product to Customer H and, as part of the same transaction, awards H a specific number of loyalty points that can be redeemed at a future date as and when the customer purchases additional products from M. 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, M 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”]), M determines that the appropriate allocation is $80 to the product sold and $20 to the loyalty points.

Because breakage is not a form of variable consideration (in this example, M always remains entitled to the original cash consideration of $100), 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 M 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 M 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 Section 8.8.1 on accounting for sales of gift certificates that may not be redeemed.

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 12.5 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.”

Sometimes, pre-CED activities result in the transfer of a good or service to an entity's 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.

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.
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. 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.

Similarly, certain fulfillment costs incurred before the CED are capitalized as costs of fulfilling an anticipated contract. If other Codification topics are applicable to pre-CED fulfillment costs, an 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 of fulfilling an anticipated contract, subject to the criteria in ASC 340-40-25-5. Once the criteria in step 1 have been met, the portion of the asset related to progress made to date should be expensed immediately. The remaining asset should be amortized over the period in which the related goods or services are 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.

The above issues are addressed in Implementation Q&As 53 and 76 (compiled from previously issued TRG Agenda Papers 33 and 34). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

Example 8-18

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 8-19

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 would generally not record a receivable (or a related contract liability) to reflect its right to payment for performance completed before meeting the step 1 criteria.

ASC 606-10-45-4 states, in part, the following (pending content effective later than the effective date of ASC 606 {in braces}):

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 Topic 310 {and Subtopic 326-20}.

Refer to Chapter 4 (step 1) for considerations related to whether an entity can account for a receivable before the contract existence criteria are met.

8.9.3 Trial Periods

In a manner consistent with the discussion in Section 4.3.1 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.

Examples 8-20 and 8-21 below illustrate the accounting for free goods or services.

**Example 8-20**

**Risk-Free Magazines**

Entity A sells sports magazines that customers are able to purchase on an annual subscription basis. Entity A’s marketing program includes a risk-free offer that allows a subscriber to receive a predefined number of magazine issues on a trial basis (but A is not obligated to provide any free magazines). For example, A will deliver up to 3 magazines on a trial basis, and upon the customer’s decision to accept the subscription offer, $12 is due and payable to A. Regardless of when the customer accepts the subscription offer during the trial period, A will deliver a total of 15 magazines (which includes the 3 “risk-free” magazines) in exchange for a nonrefundable fee of $12.

Assume that after A has delivered the first 2 trial-period magazines, the customer accepts the subscription offer and pays A a nonrefundable price of $12. Each magazine is determined to be a distinct performance obligation that is satisfied at a point in time.

The parties are not committed to perform their respective obligations until the customer accepts the subscription offer. That is, no contract exists. Once the customer accepts the offer (after 2 free magazines are delivered), A has a contract to deliver 13 additional magazines to the customer (the first 2 free magazines are a marketing offer rather than a promised good or service). Entity A would allocate the $12 transaction price to the 13 magazines (92¢ each) and recognize revenue as each magazine is transferred to the customer.

**Example 8-21**

**Bonus Magazines**

Entity A offers a marketing program that advertises that bonus magazines will be added to a subscription term. For example, upon a customer’s acceptance of an offer for an annual magazine subscription, A will supply three bonus months that result in a total of 15 magazines. Accordingly, if a customer accepts a subscription offer, the customer will receive 15 magazines for an annual nonrefundable subscription price of $12.

Once the customer accepts the subscription offer, the nature of the promise is to transfer 15 magazines to the customer for $12. Entity A would allocate the transaction price to each of the 15 magazines (80¢ per magazine) and recognize revenue as each magazine is transferred to the customer.

**8.9.4 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 5.6 for additional discussion about determining the nature of a promise and identifying performance obligations). Any up-front payment becomes a portion of the overall transaction price (see Chapter 6 for further discussion about determining the transaction price).

8.9.4.1 Recognition of Up-Front Fees Received Upon Entering Into a Contract

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 these circumstances, the up-front fee cannot be recognized as revenue immediately when it is received.

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 an entity receives consideration before the related performance obligation is satisfied, the entity should not recognize the advance payment as revenue until that obligation is satisfied. However, the entity should recognize the consideration received as a contract liability (i.e., deferred revenue) in its statement of financial position and evaluate such payment for the potential existence of a significant financing component (see Section 6.4).

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 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.
Example 8-22 below illustrates how to determine whether a nonrefundable initiation fee in a club membership contract should be recognized upon receipt.

**Example 8-22**

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.

The entity should **not** recognize the initiation fee as revenue upon receipt even though it is nonrefundable. 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. Because no performance obligation has been satisfied upon payment of that fee, 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 entity satisfies the associated performance obligations, which may include a material right.

### 8.9.5 Recognizing Revenue Related to Commissions Earned by a Sales Agent

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. See Chapter 10 for further discussion of principal-versus-agent considerations.

The timing of recognition of a sales agent’s commission revenue depends on the nature of (1) the agreement between the sales agent and its customer (the principal) and (2) the promise to the customer. 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 (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. That is, as the agent works toward achieving a sale (e.g., by meeting with the principal’s potential customer), the work performed is not consumed by the principal (i.e., the agent’s customer) until a sale is achieved. 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 (e.g., reestablish contact and build a relationship with the principal’s potential customer). Thus, the conditions for recognizing revenue over time are not met, and control of the “good or service” is not considered to be transferred. In these instances, the point in time at which revenue should be recognized will depend on the nature of the sales agent’s promise to its customer, the principal. 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.

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**Example 8-23**

**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 (as discussed above, the point in time at which revenue should be recognized will depend on the nature of the promise to the customer). 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.
Chapter 8 — Step 5: Determine When to Recognize Revenue

Example 8-24

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 8-23). The commission represents variable consideration that the agent should estimate (unless the variable consideration meets the criteria in ASC 606-10-32-40 to be allocated to the period in which the product sale occurs) and include in the transaction price, subject to the constraint.

Example 8-25

Two Separate Performance Obligations

A sales agent manages a Web site that (1) lists independent sellers' products and (2) posts advertisements of independent sellers' products. Advertisements are purchased by some of the sales agent's customers on a stand-alone basis (i.e., they are purchased by customers that do not have any products listed on the Web site) and by other customers of the sales agent that are also contracting to have their products listed for sale on the Web site.

The 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. Alternatively, if both the contract price for the advertisement and the price for arranging the sale reflect their respective stand-alone selling prices, the entity may not need to estimate the variable consideration.

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 (unless the variable consideration meets the criteria in ASC 606-10-32-40 to be allocated to the period in which the product sale occurs), and recognize revenue by using an appropriate measure of progress.
Chapter 9 — Contract Modifications

9.1 Defining a Contract Modification

9.1.1 In General

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 (i.e., creates or changes the enforceable rights or obligations in a preexisting contract), there is a contract modification.

ASC 606 defines a contract modification as follows:

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.
ASC 606-10 (continued)

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.

Under legacy 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 legacy 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:

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition in ASC 605-35</th>
<th>Definition in IAS 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim</td>
<td>“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.”</td>
<td>“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.”</td>
</tr>
<tr>
<td>Change order (U.S. GAAP) or variation (IFRS Standards)</td>
<td>“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.”</td>
<td>“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.”</td>
</tr>
</tbody>
</table>

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 16.

9.1.2 Differentiating Changes in the Transaction Price From Contract Modifications

While contract modifications often result in a change in the transaction price, not all changes in the transaction price are related to contract modifications. An entity should consider whether a change in the price is due to (1) the resolution of variability that existed at contract inception or (2) a change in the scope or price (or both) of the contract that changes the parties' rights and obligations after contract inception. An entity will need to use judgment to determine whether a change in price is the result of a change in the transaction price or a contract modification, especially when the entity provides the customer with a price concession. As noted in Section 7.6.2, this distinction is important because the resolution of variability that existed at contract inception is accounted for in accordance with ASC 606-10-32-43 and 32-44, whereas ASC 606-10-32-45 states that changes in the transaction price that are related to a contract modification are accounted for in accordance with the contract modification guidance in ASC 606-10-25-10 through 25-13.

9.1.3 Determining Whether a Contract Modification Is Approved

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 (e.g., a change in the quantity or type of goods or services to be provided or the duration of the contract) 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. Entities may need to use judgment when determining when a contract extension has been approved after the expiration of an existing contract, as highlighted in Section 4.3.1.
Example 9 in ASC 606, which is reproduced below, illustrates how an entity may be required to make certain judgments when determining whether a contract modification has been approved. In the example, the entity is required to assess the legal enforceability of a contract modification that the customer did not enter into voluntarily.

**ASC 606-10**

**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.

There may be circumstances in which an entity and its customer agree on what is often referred to as an “unpriced change order” (i.e., a change in the scope of the contract before the parties have agreed on the related change in price). In this situation, the entity should estimate the change in the transaction price in a manner consistent with the guidance on estimating variable consideration (see Section 6.3.2 for a discussion of that guidance). The entity will most likely need to use judgment in this situation and consider all relevant facts and circumstances when estimating the change in the transaction price. For example, the entity’s prior history of working in a particular industry or jurisdiction and with the specific customer may provide evidence of the price that will ultimately be approved.

Example 9-1 below illustrates the factors that an entity may consider in determining whether an unpriced change order has been approved by both parties.
Example 9-1

Entity SF designs, manufactures, and installs custom closets and other home organization systems. While SF is often engaged by individual homeowners to redesign closet space, SF also works frequently with one specific home builder, Entity PJ. During the installation of a closet system for a home that PJ is building, the two parties discuss additional enhancements to be made to the closet system. Because of time constraints on finishing the home, SF begins work on the enhancements immediately, before the parties have decided on the additional transaction price related to the change in scope.

In determining whether the change in scope has been approved and represents a contract modification, SF considers the following factors:

- The parties have worked together in the past, in the same geographic region, approximately 50 times.
- All previous contracts have been negotiated without disagreement, and the parties have a history of changing the scope of the work before negotiating an updated price. There have been no disagreements on the ultimate price change related to changes in scope.
- While the entities generally document their contracts in the form of a written contract, there has been sufficient history to enable SF to be certain that it will have an enforceable right to payment for the additional work that PJ asked it to perform.
- Entity SF believes that PJ will agree to pay for both the incremental costs of the change in scope and a reasonable profit margin in a manner consistent with SF's other contracts with PJ.
- The jurisdiction in which the agreement is in effect does not have additional legal precedent or regulations that would override or affect the legal enforceability of SF's right to payment for the additional work to be performed.

On the basis of these indicators, SF concludes that the parties have agreed to a contract modification. Entity SF estimates the change in the transaction price in a manner consistent with the guidance in ASC 606 on estimating the transaction price. Entity SF will reassess this estimate of variable consideration each reporting period until SF and PJ agree on the transaction price related to the change in scope of the modified contract.

9.1.4 Entering Into a New Contract With an Existing Customer

When an entity enters into a new contract with an existing customer, the entity should consider whether the new contract should be accounted for as a contract modification. There may be no economic difference between whether an entity and its customer modify an existing contract by (1) executing a legal contract whose extant written terms explicitly amend the scope or price of the original contract or (2) executing a new and separate legal contract that meets one or more of the criteria in ASC 606-10-25-9 to be combined with one or more contracts and accounted for as a single contract. Section 4.7 describes the factors in ASC 606-10-25-9 that an entity should consider when determining whether multiple contracts with a single customer should be combined and accounted for as a single contract.

At times, the determination of whether a new contract is a modification of an existing contract may be relatively simple. For example, an entity may be able to conclude relatively easily that a new contract does not modify an existing contract if the promised goods and services in the original contract are unrelated to and priced independently of those in the new contract (i.e., the additional goods or services are distinct and priced at their stand-alone selling prices).
However, in other circumstances, even when the new agreement is not explicitly structured as a modification to the original contract, the entity may need to use judgment when making this determination. In addition to the considerations described in Section 4.7, the entity may need to assess whether and, if so, why any of the promised goods or services are priced at a discount in the newly negotiated contract (e.g., whether the favorable terms were offered solely because of the existing relationship). The entity may also need to understand the substance of the negotiations between the two parties when executing the new agreement to faithfully depict the recognition of revenue related to the goods or services promised to the customer. For example, the revenue recognition pattern of a combined, modified contract, whose combined transaction price would need to be allocated to the goods and services of the combined contract, may be different from that of a newly negotiated contract accounted for as a separate unrelated contract, whose independent transaction price would be allocated to fewer goods and services.

9.2 Types of Contract Modifications

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 prices. Depending on whether those goods and services are distinct or sold at their stand-alone selling prices, 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 (b), in a way that faithfully reflects the economics of the transaction (see ASC 606-10-25-13(c)).

The flowchart below 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.
If the answer is "Yes" for some goods or services and "No" for others, it may be appropriate to apply both models to a single contract, in the manner described in ASC 606-10-25-13(c), on the basis of an assessment at the performance obligation level. See Section 9.2.2.

For illustrative examples, see Example 9-3; ASC 606-10, Examples 8 and 9; and Example 9-6.

For illustrative examples, see Example 9-2; ASC 606-10, Example 5, Case B; ASC 606-10, Example 7; Example 9-5; Example 9-7; and ASC 606-10, Example 6.

For an illustrative example, see ASC 606-10, Example 5, Case A.
9.2.1 Contract Modification Accounted for as a Separate 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.

When an entity accounts for a contract modification as a separate contract in accordance with ASC 606-10-25-12, the entity's accounting for the original contract is not affected by the modification. Any revenue recognized through the date of the modification is not adjusted, and remaining performance obligations will continue to be accounted for under the original contract. The new contract is accounted for separately from the original contract and on a prospective basis.

There is no economic difference between (1) a modification of an existing contract with a customer that includes additional distinct goods or services at their representative stand-alone selling prices and (2) a completely new contract entered into by the two parties for goods or services at their representative stand-alone selling prices. Therefore, a modification of an existing contract should be accounted for as a new contract that is separate and apart from the existing contract when (1) there are additional distinct goods or services promised to a customer and (2) those goods or services are in exchange for consideration that represents the stand-alone selling prices of the additional distinct promised goods or services. The change in scope must be an increase rather than a decrease in the quantity of promised goods or services because by its very nature, a new contract that decreases the quantity of goods or services promised in the original contract is inherently modifying the original contract (i.e., the new contract is not separate).

When considering whether the price charged to the customer represents the stand-alone selling prices of additional distinct promised goods or services, entities are allowed to adjust the stand-alone selling prices 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 reflect the stand-alone selling prices of additional distinct goods or services provided in the renewed contract. See Section 7.3 for a discussion of the guidance on determining stand-alone selling prices and Section 7.6 for a discussion of the guidance on changes in the transaction price.

**Connecting the Dots — 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 ofASC 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 changed over this time, X has to determine the stand-alone selling price of the additional goods to be delivered at the date of the modification 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 to be accounted for in accordance with ASC 606-10-25-12; 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 in accordance with ASC 606-10-25-13(a).

The following example in ASC 606 illustrates an entity’s assessment of whether a contract modification represents a separate contract:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 5 — Modification of a Contract for Goods</strong></td>
</tr>
<tr>
<td><strong>55-111</strong> 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.</td>
</tr>
<tr>
<td><strong>Case A — Additional Products for a Price That Reflects the Standalone Selling Price</strong></td>
</tr>
<tr>
<td><strong>55-112</strong> 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.</td>
</tr>
<tr>
<td><strong>55-113</strong> 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.</td>
</tr>
</tbody>
</table>
### 9.2.2 Contract Modification Not Accounted for as a Separate Contract

**ASC 606-10**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-13</td>
<td>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:</td>
</tr>
<tr>
<td>a.</td>
<td>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:</td>
</tr>
<tr>
<td>1.</td>
<td>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</td>
</tr>
<tr>
<td>2.</td>
<td>The consideration promised as part of the contract modification.</td>
</tr>
<tr>
<td>b.</td>
<td>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).</td>
</tr>
<tr>
<td>c.</td>
<td>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.</td>
</tr>
</tbody>
</table>

A contract modification that does not meet the requirements outlined in Section 9.2.1 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 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.

In accordance with ASC 606-10-25-13(a), if the remaining goods or services are distinct from the goods or services 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 (or distinct goods or services) 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. Such a situation would arise when there is a modification to a contract that contains (1) remaining distinct performance obligations or (2) a single performance obligation accounted for as a series of distinct goods or services under ASC 606-10-25-14(b) (see Section 5.3.3).
In contrast, in accordance with ASC 606-10-25-13(b), 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 over time. 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 because the scope of the single performance obligation increased (or is 35 percent complete because the scope of the single performance obligation decreased). 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 the goods or services 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). The boards decided that in those circumstances, it may be appropriate for an entity to apply both models to a single contract, in the manner described in ASC 606-10-25-13(c), on the basis of an assessment at the performance obligation level. An entity would do so by considering whether, for the performance obligations that are not yet fully satisfied (including those that are partially satisfied), the remaining goods or services to be transferred in accordance with the promise are distinct from the goods or services previously transferred. No change would be made to revenue recognized for fully satisfied performance obligations.

9.2.2.1 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 an entity’s promise to deliver the same good or service to a customer numerous times over an agreed-upon period, such as a performance obligation that meets the definition of a series in ASC 606-10-25-14(b). An example of an accumulating performance obligation would be a promise to perform many different procedures or activities over time to produce the final good or service to be provided to a customer, such as a performance obligation treated under ASC 606-10-25-14(a) as a bundle of goods or services that is distinct.

Example 9-2 below illustrates how an entity would account for a modification of a repetitive performance obligation that meets the requirements of ASC 606-10-25-13(a).

**Example 9-2**

**Modification of a Repetitive Performance Obligation**

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. Company A concludes that the performance obligation to deliver 10 widgets over five years qualifies for revenue recognition over time and meets the definition of a series in ASC 606-10-25-14(b). Assume that the contract does not have a significant financing component.
Chapter 9 — Contract Modifications

Example 9-2 (continued)

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. In addition, the widgets are produced sequentially, and B's request for additional widgets occurs immediately after delivery of the 5th widget but before production of the remaining widgets begins.

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.

In contrast to Example 9-2, Example 9-3 below illustrates how an entity would account for a modification of an accumulating performance obligation accounted for under ASC 606-10-25-13(b).

Example 9-3

Modification of an Accumulating Performance Obligation

Assume that the original contract in Example 9-2 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 complete 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 and in accordance with ASC 606-10-25-13(b). 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 9-2 and 9-3 side by side for comparison:

<table>
<thead>
<tr>
<th>Fact Pattern 1 (Repetitive)</th>
<th>Fact Pattern 2 (Accumulating)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract length</strong></td>
<td>January 1, 2015, through</td>
</tr>
<tr>
<td></td>
<td>December 31, 2020</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Original obligation</strong></td>
<td>Deliver 10 distinct widgets</td>
</tr>
<tr>
<td><strong>Consideration</strong></td>
<td>$10 per widget</td>
</tr>
<tr>
<td><strong>Modification date</strong></td>
<td>January 1, 2018</td>
</tr>
<tr>
<td><strong>Performance completed to date</strong></td>
<td>5 widgets delivered</td>
</tr>
<tr>
<td><strong>Total remaining consideration</strong></td>
<td>$50</td>
</tr>
<tr>
<td><strong>Additional goods and services</strong></td>
<td>Deliver 15 additional distinct widgets</td>
</tr>
<tr>
<td><strong>Price for additional goods and services</strong></td>
<td>$4 per widget</td>
</tr>
<tr>
<td><strong>Total additional consideration</strong></td>
<td>$60</td>
</tr>
<tr>
<td><strong>Are the additional goods and services both capable of being distinct and distinct in the context of the contract?</strong></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Additional goods and services at stand-alone selling price?</strong></td>
<td>No</td>
</tr>
<tr>
<td><strong>Applicable modification guidance</strong></td>
<td>ASC 606-10-25-13(a)</td>
</tr>
<tr>
<td><strong>Cumulative catch-up?</strong></td>
<td>No</td>
</tr>
<tr>
<td><strong>Cumulative catch-up amount</strong></td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Consideration to recognize prospectively</strong></td>
<td>(5 × $10) + (15 × $4) = $110</td>
</tr>
<tr>
<td></td>
<td>10 – 5 + 15 = 20</td>
</tr>
</tbody>
</table>

These two examples, which each involve a single performance obligation, demonstrate the difference in accounting for a contract modification when that single performance obligation either (1) represents a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer or (2) represents a combined performance obligation because the bundle of goods or services either (a) is not capable of being distinct or (b) is not distinct within the context of the contract. When the remaining goods or services to be transferred are distinct, the entity will, in effect, terminate the original contract and establish a "new" contract (i.e., prospectively). When the remaining goods or services to be transferred are not distinct, the subsequent accounting for an identified contract modification will be, in effect, an adjustment (through a cumulative catch-up) to the original contract.
Contract modification accounting is heavily dependent on whether the remaining goods or services to be transferred are distinct from goods or services transferred before the modification. This further highlights the importance of appropriately identifying all distinct performance obligations in a contract, including an assessment of whether one or more performance obligations in a contract are required to be accounted for as a series in accordance with ASC 606-10-25-14(b). Contract modifications are evaluated at the performance obligation level unless the performance obligation is accounted for as a series, in which case contract modifications are evaluated at the level of the distinct goods or services that make up the series, as illustrated above. See Chapter 5 for a detailed discussion of the identification of performance obligations in a contract, including the requirement to identify as a performance obligation each promise to transfer to a customer a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

The following examples in ASC 606 further illustrate a modification of a contract that contains a repetitive performance obligation (Example 7) and a modification of a contract that contains an accumulating performance obligation (Example 8):

**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. The standalone selling price of the services for years 4 through 6 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 additional 3 years of services, is $240,000, which is deemed to be an appropriate estimate of the standalone selling price of the multiyear contract.

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 additional services to be provided and concludes that they are distinct. However, the price change does not reflect the standalone selling price.

55-128 Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(a) as if it were 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.
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:

<table>
<thead>
<tr>
<th>Transaction price</th>
<th>$ 1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected costs</td>
<td>700,000</td>
</tr>
<tr>
<td>Expected profit (30%)</td>
<td>$ 300,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$ 600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td>420,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$ 180,000</td>
</tr>
</tbody>
</table>

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.
9.2.2.2 Blend-and-Extend Contract Modifications

A common transaction in the power and utilities (P&U) industry, a blend-and-extend (B&E) contract 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.

For 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 or a termination of the existing contract and the creation of a new 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.

For example, a supplier and a customer enter into a fixed-volume, five-year forward sale of electricity at a fixed price of $50 per unit. Years 1 through 3 have passed, and both parties have met all of their performance and payment obligations for those years.

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 net increase in the contract consideration (i.e., the total increase in consideration that the entity expects to be entitled to under the modified contract, including any changes to the prices of the remaining goods or services in the original contract) with the total stand-alone selling price of the goods or services added during the extension period or (2) the revised blended 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 originally added this item to its agenda. However, it 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 in accordance with ASC 606-10-25-12 (“View A”) or (2) the termination of an existing contract and the creation of a new contract in accordance with ASC 606-10-25-13(a) (“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 component.

The application of View A or View B focuses on whether the goods or services added during the extension period are priced at their stand-alone selling price. However, we believe that it is also acceptable for an entity to conclude that a B&E contract modification is always a termination of an existing contract and the creation of a new contract (i.e., an entity is not required to perform an analysis of the stand-alone selling price of the additional goods or services). The B&E contract modification is not just an increase in a contract's scope (e.g., an extension of the arrangement) in exchange for an incremental fee because the pricing of the remaining goods or services in the original contract is also adjusted. That is, if the modification does not solely add goods or services for an incremental fee as described in ASC 606-10-25-12 (i.e., the modification also adjusts the pricing of the original goods or services), it would not be accounted for as a separate contract.

A situation similar to that described above often arises in the technology industry, wherein an entity that sells a cloud-based or hosted software solution (e.g., SaaS arrangement) may modify its arrangements before the end of the initial contract term by renewing the initial contract and revising the pricing on a blended basis for the remaining term, particularly if prices have decreased. For guidance on determining the appropriate contract modification guidance to apply, see Deloitte's December 2, 2019, Technology Alert.

### 9.2.2.3 Modification and Discount for Low-Quality Products

<table>
<thead>
<tr>
<th><strong>ASC 606-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 5 — Modification of a Contract for Goods</strong></td>
</tr>
</tbody>
</table>
| **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]<sup>5</sup>

**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.  

<sup>5</sup> Case A of Example 5 is reproduced in Section 9.2.1.
Chapter 9 — Contract Modifications

ASC 606-10 (continued)

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 \( \frac{[(100 \times 60 \text{ products not yet transferred under the original contract}) + (80 \times 30 \text{ products to be transferred under the contract modification})]}{90 \text{ remaining products}} \).

Stakeholders have raised questions about Example 5, Case B, in ASC 606 (reproduced above). The example’s 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 (i.e., the modification is solely accounted for prospectively). That is, the allocation of the remaining consideration of $7,500 (which is the sum of (1) the original 60 remaining products \( \times 100 \) per product and (2) the additional 30 products \( \times 50 \) 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.

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.

For additional discussion related to differentiating changes in the transaction price from contract modifications, see Section 7.6.2.

9.2.2.4 Accounting for Contract Assets as Part of a Contract Modification

Unlike legacy 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, such as 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, such as the satisfaction of additional performance obligations (see Chapter 14). These contract 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).

View B is generally appropriate 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.”

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).

The above issue is addressed in Implementation Q&A 81 (compiled from previously issued TRG Agenda Papers 51 and 55). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

The example below illustrates the accounting for a contract asset as part of a contract modification.

### Example 9-4

Entity M enters into a contract with Customer R to sell a product and one year of service. The product and service are separate performance obligations. The one year of service is considered to be a series of distinct services that meet the criteria in ASC 606-10-25-14(b) to be accounted for as a single performance obligation satisfied over time. Entity M's performance obligation related to the product is satisfied at the point in time that the product is shipped to R, which occurs at the beginning of the first month.

The transaction price of the contract is $7,500, which is paid by R in 12 equal installments of $625 at the end of each month. Under these payment terms, the customer does not make an up-front payment when the product is shipped. The stand-alone selling price of the product is $2,700, and the stand-alone selling price of the services is $4,800 ($400 per month). Because the sum of the stand-alone selling prices equals the transaction price, the amount allocated to each performance obligation is the stand-alone selling price of that performance obligation.

At the end of six months, the contract is modified to include one additional year of service beyond the initial one-year service term. Customer R is current with all payments, and the modification does not affect the amounts due for the remaining six months of service under the initial one-year service term (i.e., R continues to pay $625 each month for the remaining six months of the initial one-year service term). The price for the additional one year of services is $100 per month, which does not represent the stand-alone selling price of the services. Because the remaining services to be provided are distinct from the product and services already delivered to R, the modification is accounted for prospectively under ASC 606-10-25-13(a).

The journal entries below illustrate how M should recognize revenue at contract inception and in the months leading up to the contract modification. For simplicity, the journal entries ignore any effect of a significant financing component.

---

6 Quoted from Q&A 81 of the FASB staff’s *Revenue Recognition Implementation Q&As* (the “Implementation Q&As”).
**Example 9-4 (continued)**

At contract inception, to recognize revenue for the product shipped to R:

<table>
<thead>
<tr>
<th>Contract asset</th>
<th>2,700</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>2,700</td>
</tr>
</tbody>
</table>

At the end of each of months 1 through 6, to recognize revenue for the monthly services:

<table>
<thead>
<tr>
<th>Cash or accounts receivable</th>
<th>625</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>400</td>
</tr>
<tr>
<td>Contract asset</td>
<td>225</td>
</tr>
</tbody>
</table>

After six months, immediately before the modification, M has recognized revenue of $5,100 ($2,700 for the product and $2,400 for the services) and has a cumulative contract asset balance of $1,350.

Entity M would retain the original contract asset of $1,350 on the modification date. The remaining consideration to be allocated consists of two components:

- $2,400 for the transaction price not yet recognized as revenue under the initial contract ($625 per month × 6 months remaining, less $1,350 contract asset balance).
- $1,200 for the additional one year of services ($100 per month × 12 months).

The total transaction price for the modified contract of $3,600 ($2,400 + $1,200) is allocated to the remaining months of service under the modified contract term; as a result, M recognizes revenue of $200 per month for the remaining 18-month contract term. The contract asset that existed on the modification date will be reduced as amounts received or receivable exceed revenue recognized; once the contract asset is recovered, amounts received or receivable in excess of revenue recognized will be reflected as a contract liability. This is reflected in the journal entries below.

At the end of each of months 7 through 9:

<table>
<thead>
<tr>
<th>Cash or accounts receivable</th>
<th>625</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>200</td>
</tr>
<tr>
<td>Contract asset</td>
<td>425</td>
</tr>
</tbody>
</table>

At the end of month 10:

<table>
<thead>
<tr>
<th>Cash or accounts receivable</th>
<th>625</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>200</td>
</tr>
<tr>
<td>Contract asset</td>
<td>75</td>
</tr>
<tr>
<td>Contract liability</td>
<td>350</td>
</tr>
</tbody>
</table>
Example 9-4 (continued)

Before revenue is recognized at the end of month 10, the cumulative contract asset balance is only $75 ($1,350 – ($425 × 3)). When a contract asset is fully recovered (i.e., is reduced to zero), consideration received in excess of revenue recognized is reflected as a contract liability. Consequently, a contract liability is recorded for the remaining amounts that are received or receivable in excess of revenue recognized.

For each of months 11 and 12, the contract liability will be recorded in the manner shown in the journal entry below.

**At the end of each of months 11 and 12:**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or accounts receivable</td>
<td>625</td>
</tr>
<tr>
<td>Revenue</td>
<td>200</td>
</tr>
<tr>
<td>Contract liability</td>
<td>425</td>
</tr>
</tbody>
</table>

As of the end of month 12, the cumulative contract liability balance is $1,200; and beginning with month 13, amounts due under the modified contract are reduced to $100 per month. Revenue recognized for each month of service continues to be $200. This is reflected in the journal entry below for each of months 13 through 24.

**At the end of each of months 13 through 24:**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or accounts receivable</td>
<td>100</td>
</tr>
<tr>
<td>Contract liability</td>
<td>100</td>
</tr>
<tr>
<td>Revenue</td>
<td>200</td>
</tr>
</tbody>
</table>
Example 9-4 (continued)

The results of this model are summarized in the table below.

<table>
<thead>
<tr>
<th>Month</th>
<th>Cash Received or Receivable</th>
<th>Revenue Recognized</th>
<th>Cumulative Contract Asset Balance</th>
<th>Cumulative Contract Liability Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>—</td>
<td>2,700</td>
<td>2,700</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>625</td>
<td>400</td>
<td>2,475</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>625</td>
<td>400</td>
<td>2,250</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>625</td>
<td>400</td>
<td>2,025</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>625</td>
<td>400</td>
<td>1,800</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>625</td>
<td>400</td>
<td>1,575</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>625</td>
<td>400</td>
<td>1,350</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>625</td>
<td>200</td>
<td>925</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>625</td>
<td>200</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>625</td>
<td>200</td>
<td>75</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>625</td>
<td>200</td>
<td>—</td>
<td>(350)</td>
</tr>
<tr>
<td>11</td>
<td>625</td>
<td>200</td>
<td>—</td>
<td>(775)</td>
</tr>
<tr>
<td>12</td>
<td>625</td>
<td>200</td>
<td>—</td>
<td>(1,200)</td>
</tr>
<tr>
<td>13</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(1,100)</td>
</tr>
<tr>
<td>14</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(1,000)</td>
</tr>
<tr>
<td>15</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(900)</td>
</tr>
<tr>
<td>16</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(800)</td>
</tr>
<tr>
<td>17</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(700)</td>
</tr>
<tr>
<td>18</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(600)</td>
</tr>
<tr>
<td>19</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(500)</td>
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<td>20</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(400)</td>
</tr>
<tr>
<td>21</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(300)</td>
</tr>
<tr>
<td>22</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(200)</td>
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<tr>
<td>23</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>(100)</td>
</tr>
<tr>
<td>24</td>
<td>100</td>
<td>200</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>
9.2.2.5 Accounting for Capitalized Costs of Obtaining a Contract When a Contract Is Modified

ASC 340-40-25-1 requires entities to capitalize incremental costs incurred to obtain a contract with a customer when such costs are expected to be recovered. ASC 340-40-35-1 requires entities to amortize such capitalized costs “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 be related to goods or services to be transferred under specific anticipated contracts. See Section 13.4.1.3 for a discussion of how to account for capitalized costs incurred to obtain a contract that are still recorded at the time of a contract modification.

9.2.2.6 Customer’s Exercise of a Material Right

As noted in Section 11.7, the TRG discussed questions raised by stakeholders about the accounting for a customer’s exercise of a material right. Specifically, stakeholders questioned whether an entity should account for a customer’s exercise of a material right in one of the following ways:

- **Alternative A** — As a change in the contract’s transaction price such that the additional consideration, along with the consideration from the original contract that was allocated to the material right, would be allocated to the performance obligation underlying the material right and would be recognized when or as the performance obligation underlying the material right is satisfied.

- **Alternative B** — As a contract modification, which may require reallocation of consideration between existing and future performance obligations.

Although most TRG members thought that both Alternatives A and B could be supported by the new revenue standard, most TRG members leaned toward Alternative A. Accordingly, we believe that while the guidance in ASC 606 supports the two alternatives outlined above, it is generally preferable to account for a customer’s subsequent exercise of a material right as if it were a separate contract (Alternative A) rather than as if it were the modification of an existing contract (Alternative B). See Section 11.7 for further discussion.

**Connecting the Dots — Marketing Offer Versus Material Right**

A customer’s exercise of an option to purchase additional goods or services that was accounted for as a “marketing offer” is different from a customer’s exercise of a material right contained within the original contract. We generally would not consider it appropriate for an entity to analogize to the alternatives outlined above on the basis of the TRG discussion when accounting for a marketing offer. Example 50 in ASC 606 (reproduced in Section 11.2) illustrates a contract with an option for additional services that is akin to a marketing offer rather than a material right because the prices of the additional services under the option represent the stand-alone selling prices of those services. Because a marketing offer in an original contract is not accounted for as a material right and therefore is not treated as part of the original contract, the exercise of the marketing offer at a subsequent date should be accounted for as a new contract (i.e., the exercise of the marketing offer is a separate contract because the additional goods or services are distinct and priced at their stand-alone selling prices).
9.2.2.7 **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 adds or removes promised goods or services or changes the contract price. There can be situations in which part of a contract is terminated and the change would be a contract modification.

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 a contract modification that results in a **decrease** in scope (i.e., the removal from the contract of promised goods or services) 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 (i.e., by its very nature, a new contract that decreases the quantity of goods or services promised in the original contract is inherently modifying the original contract and is not separate).

**Example 9-5**

**Application of ASC 606-10-25-13(a) to a Modification Resulting in a Reduction in the Scope of a Contract That Provides for a Series of Distinct Goods or Services Accounted for Under ASC 606-10-25-14(b)**

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, creating a contract liability of $20. 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).

Entity Y could alternatively calculate the $30 allocated to the services still to be provided by considering the $50 of the original transaction price yet to be recognized ($140 transaction price, less the $40 recognized as revenue for delivery of Product X and the $50 recognized as revenue for services provided to date), less the $20 reduction of the total transaction price since the customer agrees to pay only an additional $10. As a result, Y would allocate $30 ($50 in remaining revenue to be recognized under the original contract less the $20 reduction of the transaction price) to the services still to be provided.
Example 9-6

**Application of ASC 606-10-25-13(b) to a Modification Resulting in a Reduction in the Scope of a Contract That Contains a Single Combined Performance Obligation Accounted for Under ASC 606-10-25-14(a)**

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. Therefore, X concludes that the contract contains a single combined performance obligation in accordance with ASC 606-10-25-14(a). In addition, X concludes that the performance obligation should be recognized over time in accordance with ASC 606-10-25-27. Four months into the contract term, the customer decides to purchase a component of the project from an alternative source; X agrees to this contract modification, which reduces the contract scope.

Since 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).

Example 9-7

**Application of ASC 606-10-25-13(a) to a Partial Termination of a Contract That Provides for a Series of Distinct Goods or Services Accounted for Under ASC 606-10-25-14(b)**

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(a), 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).

ASC 606-10-25-5 states that an entity should reassess the criteria in ASC 606-10-25-1 for identifying a contract with a customer 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 significant 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 an entity, 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, the entity performs a reassessment of the variable consideration and determines that it is no longer constrained. As a result of this reassessment, the entity 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 ASC 606, 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).
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.

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.

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
10.2 Determining Whether an Entity Is Acting as a Principal
10.3 Determining Whether an Entity Is Acting as an Agent
10.4 Contracts in Which the Entity Is a Principal and an Agent
10.5 Other Considerations
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 legacy U.S. GAAP, the new revenue standard requires a degree of judgment to be used in the assessment of whether an entity is acting as a principal or as an agent. However, legacy 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 legacy 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 legacy 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 for further details of the differences.

10.1.1 Identifying the Specified 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.

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 specified 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. That is, the same guidance that an entity applies to identify performance obligations (ASC 606-10-25-19 through 25-22) will be used to determine the specified goods or services.

10.1.2 Determining Whether the Entity Controls the Goods or Services Before They Are Transferred to the Customer

An entity is a principal in providing a specified good or service if the entity controls that specified good or service before it is transferred to the customer. Control is defined in ASC 606-10-25-25 as “the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.” In addition, ASC 606-10-55-39 provides indicators to support an entity’s evaluation of control.

Changing Lanes — Comparison of Indicators in the Principal-Versus-Agent Analysis Under Legacy and New Revenue Guidance

As mentioned in Section 10.1, the manner of determining whether an entity is a principal or an agent under legacy 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 legacy and new revenue guidance:

<table>
<thead>
<tr>
<th>Purpose of Indicators: To identify whether the entity has risks and rewards of the principal (ASC 605-45)</th>
<th>Purpose of Indicators: To determine whether the entity controls the goods or services before they are transferred to the customer (ASC 606)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The entity is the primary obligor.</td>
<td>The entity is primarily responsible for fulfilling the promise to provide the specified good or service.</td>
</tr>
<tr>
<td>The entity has general inventory risk before the customer order is placed or upon customer return.</td>
<td>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).</td>
</tr>
<tr>
<td>The entity has latitude in establishing the price.</td>
<td>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.</td>
</tr>
</tbody>
</table>
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 legacy guidance to transfer of control under the new revenue standard, and this change affects how the indicators are evaluated.

In general, an entity applying legacy 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 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 legacy U.S. GAAP and the new revenue standard is how the indicators are weighted. Under legacy 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.”

At the 13th Annual Life Sciences Accounting & Reporting Congress held on March 21, 2017, then SEC Chief Accountant Wesley Bricker highlighted the changes in the guidance on analyzing whether an entity is acting as a principal or as an agent. He reminded preparers to (1) carefully evaluate each arrangement to understand the economic substance and (2) use judgment in determining the appropriate manner of presentation. Mr. Bricker described the new control-based model that replaces the risks-and-rewards-based model and that therefore requires entities to update their evaluations. In addition, because no two arrangements are identical, he reminded preparers to go beyond benchmarking to their peers’ accounting policies to fully understand each underlying transaction so that they can apply the principles of ASC 606. Further, he noted that preparers need to identify the pertinent facts and related judgments that must be disclosed under the new revenue standard.

<table>
<thead>
<tr>
<th>Purpose of Indicators: To identify whether the entity has risks and rewards of the principal (ASC 605-45)</th>
<th>Purpose of Indicators: To determine whether the entity controls the goods or services before they are transferred to the customer (ASC 606)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The entity changes the product or performs part of the service.</td>
<td>Indicator not used in ASC 606.</td>
</tr>
<tr>
<td>The entity has discretion in supplier selection.</td>
<td>Indicator not used in ASC 606.</td>
</tr>
<tr>
<td>The entity is involved in the determination of product or service specifications.</td>
<td>Indicator not used in ASC 606.</td>
</tr>
<tr>
<td>The entity has physical loss inventory risk after the customer order or during shipping.</td>
<td>Indicator not used in ASC 606.</td>
</tr>
<tr>
<td>The entity has credit risk.</td>
<td>Indicator not used in ASC 606.</td>
</tr>
</tbody>
</table>
In a manner similar to how an entity performs the principal-versus-agent analysis under legacy 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:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-37</strong> 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.</td>
</tr>
<tr>
<td><strong>55-37A</strong> 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:</td>
</tr>
<tr>
<td>a. A good or another asset from the other party that it then transfers to the customer.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

### 10.2.1 Controlling a Good Before Transferring It to a Customer

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.

For example, an online clothing retailer obtains physical possession of goods (inventory) from its designers and stores the goods in its warehouse. The retailer separately enters into contracts with customers to sell goods held in its warehouse. In this example, it is clear that the retailer controls the goods before transferring them to the customer.

However, other scenarios may not be as clear. Consider a situation in which an online retailer holds some goods (inventory) in its warehouse but also has arrangements with some of its suppliers that allow it to direct the supplier to ship certain goods directly from the supplier's warehouse to the end customer (i.e., it does not have inventory risk for all goods). This sort of an arrangement would have to be evaluated more carefully, as illustrated below.
Example 10-1

An electronics retailer has physical locations but also sells goods to its customers through its Web site. Customers can choose to purchase goods at the retailer's physical location but can purchase the same goods online. The retailer has full discretion in determining the price of the goods and generally offers the same price in stores as it does online. Customers who choose to buy electronics online enter into a contract with the retailer to purchase one or more specified goods. The retailer can satisfy its obligation to transfer a specified good to a customer either by shipping the good from one of its physical locations or by directing its supplier to ship the good from the supplier's warehouse. If the retailer directs its supplier to ship the good directly to the customer, the retailer will take title to the specific good only momentarily before title passes to the customer upon shipment. The retailer is required to pay the supplier for the good even if it does not receive payment from the customer. If the customer is not satisfied with the good or there is a defect, the customer can return the good to one of the retailer's physical locations.

In this case, because the retailer takes title to the good only momentarily before passing title on to the customer, it may not be clear whether the retailer controls the specified good before the good is transferred to the customer. That is, further consideration is required. However, the retailer may conclude that it controls the good before the good is transferred to the customer because it has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good (i.e., it directs the supplier to ship the good to the retailer's customer). In addition, after considering the control indicators discussed below, the retailer concludes that it is the principal because it is primarily responsible for satisfying the performance obligation, it has some inventory risk upon product return, and it has latitude to establish pricing — factors that further indicate that it controls the good before the good is transferred to the customer. Therefore, the retailer concludes that it should record revenue on a gross basis.

Example 10-1 is similar to a fact pattern discussed by Sheri York, then professional accounting fellow in the SEC's Office of the Chief Accountant (OCA), in a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments. In her speech, Ms. York made the following observations related to the determination of whether an entity is a principal or an agent when the entity never obtains physical possession of the specified good:

Application of the principal versus agent guidance can be especially challenging when an entity never obtains physical possession of a good (for example, when goods are shipped directly from a manufacturer to the third party). Over the past year OCA has received questions regarding the principal versus agent determination in these types of fact patterns, including fact patterns where the company concluded it was acting as a principal and others where the company concluded it was acting as an agent. I would like to share one of the consultations that OCA received on this topic.

In this consultation, the registrant distributed a wide variety of healthcare-related goods to retailers. The registrant maintained inventory for the majority of the goods sold; however, for certain specialized goods, the manufacturer shipped the goods directly to the retailer. The registrant managed the return process with the retailer; however, due to regulatory reasons, certain returned goods were returned directly to the manufacturer.

The registrant concluded that it was acting as a principal in the arrangement because it controlled the specified good before it was transferred to the customer. That is, the registrant had the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods. As part of its assessment of control, the registrant considered the indicators of control and concluded that it was primarily responsible for fulfillment and had discretion in establishing the price at which the goods were sold to the retailer. The registrant believed that it was primarily responsible for fulfillment based on the terms of the agreement and marketing materials communicated to the customer. In this fact pattern, the registrant was the primary point of contract with the retailer, and was contractually responsible for ensuring that products were acceptable to the retailer, including responsibility for issues related to delivery, quantity, and spoilage.

In this fact pattern, the staff did not object to the registrant's conclusion that it was the principal in the transaction. Based on my experience, I think it is important to remember that the conclusion as to whether or not an entity is a principal or an agent requires a consideration of the definition of control, often including consideration of the indicators of control, of which inventory risk is only one of the possible indicators. In some circumstances, physical possession will not coincide with control of a specified good. [Footnotes omitted]
Typically, the principal in a transaction to sell goods to its customer will have legal title to the goods before they are transferred to the customer. However, ASC 606-10-55-37 states that “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.” Nevertheless, we do not believe that having legal title only momentarily (e.g., flash title) automatically precludes the entity from having control of the goods before they are transferred to the customer. Accordingly, the entity will need to perform a thorough analysis of the overall definition of control and the other indicators in ASC 606-10-25-30 and ASC 606-10-55-39 to determine whether it has the ability to control the goods before they are transferred to the customer.

Example 10-2 below considers whether an entity's momentary legal title to goods that the entity sells to an end customer automatically precludes a determination that the entity (1) has control of the goods before selling them to the end customer and (2) is therefore the principal in the transaction.

**Example 10-2**

Company L, the owner and operator of retail stores that sell clothing and accessories to customers, enters into contracts with clothing manufacturers to purchase clothing that is based on L's specifications. Upon receiving a purchase order from L, a manufacturer produces the clothing and ships it to L's warehouse. Company L subsequently delivers the clothing to its individual retail stores for sale to end consumers. At its own discretion, L will direct the use of the clothing by specifying the stores to which the clothing is to be delivered.

The manufacturer retains legal title to the clothing until L sells the clothing to an end consumer. Upon L's sale of the clothing to the end consumer, legal title is transferred only momentarily to L and then is immediately transferred from L to the end consumer (i.e., flash title transfer). Consequently, L has physical possession of the clothing but has legal title to the clothing only momentarily before selling it to the end consumer. However, L can obtain the economic benefits of the clothing because it has the unilateral ability to sell the clothing to an end consumer despite having legal title to the clothing only momentarily before the sale. In addition, the manufacturer does not have the ability to recall the clothing or direct it to another retailer once it has been shipped to L. Further, L is not obligated to pay the manufacturer for any clothing purchased until such clothing is sold to the end consumer.

We do not believe that having legal title to the clothing only momentarily automatically precludes L from having control of the clothing. To be considered a principal in a transaction, an entity must have control of the specified good or service before transferring that good or service to a customer, as stated in ASC 606-10-55-37. Legal title is one of the indicators of control in ASC 606-10-25-30, but that indicator alone is not determinative of whether an entity has control of an asset. As indicated in ASC 606-10-25-30(b) and discussed in Section 8.6.4.1, there are circumstances in which control of an asset can be transferred to the customer even though the seller retains legal title to the asset until the asset is sold to the end consumer. In the fact pattern outlined above, L must consider the overall definition of control and the other indicators in ASC 606-10-25-30 and ASC 606-10-55-39 to determine whether it obtains control of the clothing without taking legal title to the clothing.

ASC 606-10-25-25 states, in part:

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.

Under the facts of this example, L has the ability to direct the use of the clothing by delivering the clothing to L's individual retail stores for resale to end consumers. Further, L can obtain the remaining benefits from the clothing by selling it to end consumers. Although the manufacturer retains legal title to the clothing until it is sold, the manufacturer does not have the ability to prevent L from directing the clothing to L's retail stores and selling the clothing to end consumers. Therefore, notwithstanding that L has legal title to the clothing only momentarily and is not obligated to pay the manufacturer for the clothing until the clothing is sold to the end consumer, L controls the clothing as the principal in the transaction in the absence of any indicators under ASC 606-10-55-39 to the contrary.
10.2.2 Controlling the Right to a Service

There may also be instances in which an entity controls a right to a service (e.g., a voucher or ticket) 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 (e.g., prepurchasing 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. In addition, an entity may control the right to a service if it directs the service provider to perform the service on the entity’s behalf for any of the entity’s customers.

Example 10-3

Entity A enters into a management agreement with Customer B to provide lawn maintenance services, including fertilization, mowing and trimming, and periodic seeding. Entity A does not provide lawn maintenance services itself; rather, it contracts with third-party service providers for each aspect of the lawn maintenance service. Entity A and Customer B have agreed on a single price for the lawn maintenance service.

Entity A separately enters into contracts with third-party service providers and directs those service providers to perform each aspect of the lawn maintenance services. Once A enters into contracts with the third-party service providers, it can direct those service providers to perform services on A’s behalf for any number of its customers.

Even though A is not performing the services, it controls the right to the services by directing specific lawn maintenance service providers to perform each aspect of the lawn maintenance services. Because A controls the right to the services, A concludes that it is acting as the principal.

Example 10-3 has similarities to a fact pattern discussed by Lauren Alexander, professional accounting fellow in the OCA, in a speech at the 2019 AICPA Conference on Current SEC and PCAOB Developments. In her speech, Ms. Alexander made the following observations related to the determination of whether an entity is a principal or an agent in a contract to provide specified services to a customer:

Determining whether an entity is a principal or an agent in a revenue transaction can be particularly challenging when two parties are involved in providing services to a customer, especially if some of the services can only be provided by a specific service provider.

In the consultation that I will discuss today, the registrant entered into contracts with customers to provide several related services in exchange for a fee. The contracts acknowledged that another service provider would provide some of the services, and the services were marketed to customers using the brand names of both the registrant and the other service provider. The registrant sought the staff’s view on whether it was a principal or an agent in the revenue transaction.

The registrant noted that some of the services promised in the contract were based on its proprietary content, and that it was heavily involved in providing those services to the customer, with limited involvement from the other service provider. However, due to certain regulatory restrictions, the registrant could not legally provide some of the services promised in the contract and therefore had to rely entirely on the other service provider to deliver those services.

The registrant concluded that it was the principal in the transaction for each of the specified services and should record revenue on a gross basis because it controlled the services before transferring them to the customer. In reaching this conclusion, the registrant stated that it had the contractual ability to direct the other service provider to provide services to customers on its behalf, and customers did not have contractual relationships with the other service provider. The registrant asserted that it was primarily responsible for fulfilling the promise to provide the specified services.

However, the registrant noted that it only had the right to dictate certain general parameters about the services to be provided by the other service provider, and that the other service provider had discretion in determining exactly how to fulfill its obligation. The registrant said that it controlled when the other service provider delivered the services, and that contractually the other service provider did not have the right to deny services to customers. Finally, the registrant was responsible for handling most customer concerns that arose from the services provided by the other service provider.
In this fact pattern, the staff did not object to the registrant’s conclusion that it was the principal in the transaction and should record revenue on a gross basis. The staff observed that the registrant could control the specified services by entering into a contract with another service provider in which the registrant defined the scope of services to be performed on its behalf, even if the registrant could not fulfill the contract using its own resources (that is, it could not legally provide certain of the services promised in the contract).

As discussed in previous staff speeches, we continue to observe that applying the principal versus agent guidance may require significant judgment, especially in the case of emerging business models. We encourage registrants to carefully consider their specific facts and circumstances and contractual terms, and any changes to these terms over time, when applying this guidance. [Footnotes omitted]

10.2.3 Integrating a Good or Service From a Third Party With a Good or Service Controlled by the Entity

An entity would also be a principal when it integrates a good or service provided by a third party with other goods or services controlled by the entity. The entity’s performance obligation may be to transfer to the customer a distinct bundle of goods or services, a component of which is provided by the third party. The entity would need to obtain control of the third party’s good or service to integrate the good or service with the other goods or services promised to the customer. For example, a general contractor may enter into a contract with a customer to construct a house. The general contractor will most likely need to combine goods or services provided by third parties (e.g., subcontractors) to transfer the promised goods or services to its customer.

Example 10-4

Contractor A enters into a contract with Customer B to construct a house. Customer B requests that a specific brand of air-conditioning unit be included in the finished house. The contractor buys the air-conditioning unit from a third party (either the contractor is reimbursed by the customer or the contract price includes the price of the air-conditioning unit), completes the installation, and performs tests to ensure that the air-conditioning unit is working. That is, as part of its obligation to construct the house for the customer, A performs a significant service of integrating the air-conditioning unit into the house, which forms part of a single performance obligation. Contractor A therefore concludes that it controls the air-conditioning unit before the unit is transferred to the customer as part of the completed house.

10.2.4 Indicators That an Entity Is Acting as a Principal

In situations such as those described in Examples 10-3 and 10-4 (above), an entity controls specified goods or services before they are transferred to the customer. This may be the case even 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, as illustrated in Example 10-1. In these circumstances, the entity will need to consider the indicators in ASC 606-10-55-39 and 55-39A when evaluating whether it is acting as a principal. Those indicators are listed and explained as follows:
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.

d. Subparagraph superseded by Accounting Standards Update No. 2016-08.

e. Subparagraph superseded by Accounting Standards Update No. 2016-08.

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, 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 legacy U.S. GAAP. In addition, discretion in establishing pricing is also an indicator for gross reporting under legacy U.S. GAAP. However, under legacy 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 legacy U.S. GAAP that it is the principal in the transaction.

We have observed that primary responsibility and inventory risk tend to be important indicators in the overall principal-versus-agent analysis under the new revenue standard. However, the relevance of particular control indicators may vary depending on the fact pattern. Consequently, an entity that relied on either being the primary obligor or having general inventory risk to support the presentation conclusions under legacy 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.
As discussed in ASU 2016-08, the FASB and IASB acknowledge that the indicators under the new revenue standard are similar to indicators used under legacy U.S. GAAP. Specifically, paragraphs BC16 through BC18 state, in part:

BC16. The Boards’ considerations (explained in paragraph BC382 of Update 2014-09) highlight that the indicators in paragraph 606-10-55-39 were included to support an entity’s assessment of whether it controls a specified good or service before it is transferred to the customer. The indicators (a) do not override the assessment of control, (b) should not be viewed in isolation, (c) do not constitute a separate or additional evaluation, and (d) should not be considered a checklist of criteria to be met in all scenarios. 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.

BC17. The Boards decided to carry over some of the indicators in previous revenue recognition standards even though those indicators have a different purpose in the new standard. In the new standard, the indicators support the concepts of identifying performance obligations and the transfer of control of goods or services. Accordingly, the Boards had expected that the conclusions about principal versus agent under Topic 606 could be different in some scenarios from those reached under the previous revenue recognition standards. Furthermore, the Boards observed that although exposure to risks and rewards alone does not give an entity control, exposure to risks and rewards can be a helpful factor to consider in determining whether an entity has obtained control (see paragraph 606-10-25-30).

BC18. The Boards decided to amend the indicators in paragraph 606-10-55-39 to more clearly establish a link between the control principle and the indicators by:

a. Reframing the indicators as indicators of when an entity controls a specified good or service before transfer, rather than as indicators that an entity does not control the specified good or service before transfer.

b. Adding guidance to explain how each indicator supports the assessment of control as defined in paragraph 606-10-55-39. This should help entities apply indicators that are similar to those in the previous revenue recognition guidance but within the context of the control principle in Topic 606.

c. Removing the indicator relating to the form of the consideration. Although that indicator might sometimes be helpful in assessing whether an entity is an agent, the Boards concluded that it would not be helpful in assessing whether an entity is a principal.

d. Removing the indicator relating to exposure to credit risk. The feedback on the proposed Update highlighted that exposure to credit risk is generally not a helpful indicator when assessing whether an entity controls the specified good or service. Stakeholders observed that the credit risk indicator in the previous revenue guidance has been problematic from the perspective of entities trying to use exposure to credit risk to override stronger evidence of agency. The Boards concluded that removing the credit risk indicator should reduce some of the complexity in the principal versus agent evaluation because the credit risk indicator typically will be less (or not) relevant to the evaluation for contracts with customers within the scope of Topic 606.

e. Clarifying that the indicators are not an exhaustive list and merely support the assessment of control. They do not replace or override that assessment. The Boards decided to explicitly state that one or more of the indicators might provide more persuasive evidence to support the assessment of control in different scenarios.

As noted above, the indicators are intended to support the conclusion that the entity controls the specified goods or services before they are transferred to the customer. Typically, the principal that controls the specified goods or services will exhibit some or all of the control indicators. The indicators also help an entity evaluate whether it is exposed to significant risks and rewards associated with the contract with the customer. As also noted above, considering whether an entity has exposure to risks and rewards can be helpful (although this indicator alone would not confirm that the entity has control). Since the principal in a transaction is typically exposed to significant risks and rewards associated with the contract with a customer, the indicators help confirm whether an entity controls specified goods or services before they are transferred to a customer (and is therefore deemed to be the principal).
In a speech at the 2017 AICPA Conference on Current SEC and PCAOB Developments, Barry Kanczuker, associate chief accountant in the OCA, provided the following guidance on determining whether an entity is a principal or an agent:

I have observed that applying [the guidance in ASC 606 on determining whether an entity is a principal or an agent] can be challenging in some fact patterns. I believe that some of the challenges are amplified in certain industries, such as the digital advertising industry or other industries in the technology space, where there are often multiple parties involved in providing the good or service, and transactions often take place within the blink of an eye.

Last year at this conference, [then OCA Professional Accounting Fellow] Ruth Uejio made remarks that principal versus agent considerations in evolving business models may create “unique challenges that will require sound judgment.” I would like to continue this discussion. For example, I believe determining whether an entity controls a specified good or service immediately prior to the good or service being transferred to the customer may be especially challenging in certain types of service transactions, such as when enforceable contracts only exist among the parties once the service is being provided, or in transactions that take place in an instant. Topic 606 does provide indicators to support an entity’s assessment of whether it controls a specified good or service before it is transferred to the customer. However, these indicators of control should not be considered a checklist of criteria. 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. I believe that determining the relevance of an indicator to the assessment of control in certain types of transactions will require reasonable judgment.

As an example of the application of this guidance, I would like to share a recent pre-filing consultation that OCA received in the digital advertising space. In this consultation, the registrant’s customer, an advertiser, provided the registrant with specifications of the target audience it wished to reach through its digital advertising efforts. The advertiser’s specifications also included limited pricing information, such as the total advertising budget over a period of time. The registrant’s technology enabled it to identify and purchase advertising space that met the advertiser’s specifications on a real-time basis, as internet users in the advertiser’s target audience were browsing a website or viewing an app with available advertising space. The registrant had the ultimate discretion, including pricing discretion, for individual purchases of advertising space. The advertiser held the registrant responsible for reaching the advertiser’s target audience and otherwise meeting the advertiser’s specifications, and typically did not receive any information from the registrant that identified the specific websites or apps from which the registrant purchased the advertising space.

The registrant concluded that it was acting as a principal in the arrangement because it controlled the specified good or service before it was transferred to the customer. As part of its assessment of control, the registrant considered the indicators of control and noted that it was primarily responsible for fulfillment and had discretion in establishing the price. The staff views principal versus agent considerations to be an area that requires reasonable judgment — in this case, based on the facts and circumstances and the Topic 606 guidance, the staff did not object to the registrant’s conclusion that it was the principal in the transaction.

I want to be clear: an area of significant judgment does not mean that the standard permits optionality. In order to make these reasonable judgments, I believe that registrants need to “roll up their sleeves” to understand the nuances of the transactions and faithfully apply the Topic 606 model to their specific set of facts and circumstances. [Footnotes omitted]

Each of the indicators in ASC 606 that an entity is acting as a principal is further discussed below.
10.2.4.1 **Primary Responsibility**

The entity that has primary responsibility for fulfilling the obligation to the customer is often the entity that is most visible to the customer and the entity from which the customer believes it is acquiring goods or services. Often, the entity that has primary responsibility for fulfilling the promise to transfer goods or services to the customer will assume fulfillment risk (i.e., risk that the performance obligation will not be satisfied) and risks related to the acceptability of specified goods or services. That is, such an entity will typically address customer questions and complaints, rectify service issues, accept product returns, or be primarily responsible for exchanges or refunds. For example, when a customer purchases a flight on a Web site operated by a company that aggregates flight information and facilitates payment (e.g., a travel site), the airline rather than the travel site has the primary responsibility to provide the transportation service to the customer. If the flight were to be canceled or if baggage were to be lost, the customer would contact the airline to address the issue. Although the customer initially interacted with the travel site to arrange for the flight, the airline is primarily responsible for fulfilling the obligation to provide transportation services to the customer.

Similarly, in Example 10-1, when a customer purchases a good from an online retailer’s Web site that is shipped directly to the customer from the supplier, the customer would contact the retailer if there are quality issues or would return the good to the retailer if there is a defect. That is, even though the good was actually shipped directly from the supplier to the customer, the customer views the retailer as being primarily responsible for fulfilling the promise to transfer the specified good, and the retailer assumes significant risk related to fulfillment of that promise.

In some cases, it can be difficult to establish whether an entity has primary responsibility for fulfilling a promise to provide a specified good or service, and doing so may require significant judgment. For example, when two parties are involved in providing a specified good or service to a customer, both parties may have contact with the customer. Conversely, in other cases, it may be clear that an entity has primary responsibility. If it is clear that an entity has primary responsibility for fulfilling a promise to provide a specified good or service to a customer, we believe that this would typically mean that the entity is deemed to be the principal. Although ASC 606-10-55-39 lists primary responsibility as only an indicator, ASC 606-10-55-36 makes clear that when the principal-versus-agent analysis is performed, it is key to identify which party is promising to provide the specified good or service to the customer. If an entity has primary responsibility to the customer for providing a specified good or service, it will usually follow that the entity is the party that is promising to provide the good or service to the customer (i.e., the entity is a principal, not an agent), even if the entity has engaged another party (e.g., a subcontractor) to satisfy some or all of the performance obligation on its behalf.

10.2.4.2 **Inventory Risk**

When an entity has inventory risk, it is exposed to economic risk associated with either (1) holding the inventory before a customer is identified or (2) accepting product returns and being required to mitigate any resulting losses by reselling the product or negotiating returns with the supplier.

While holding the inventory, the entity bears the risk of loss as a result of obsolescence or destruction of inventory. This risk is generally referred to as front-end inventory risk. In the case of a service, the entity may commit to pay for a service before it identifies a customer for the service. This is also a form of inventory risk.
Another type of inventory risk is back-end inventory risk, which is economic risk assumed upon product return (when there is a general right of return). If an entity is willing to assume economic risk upon product return (and there is a general right of return), it is assuming some risk that is assumed by a principal in a transaction. However, in some instances, an entity may be willing to accept a return only if it can return the product to the supplier, in which case back-end inventory risk may be mitigated. When combined with other factors, the existence of back-end inventory risk may lead to a conclusion that the entity controls the specified good or service before it is transferred to the customer even if another party transfers the product or service directly to the customer. In Example 10-1, the online retailer does not have inventory risk before entering into a contract with a customer because the online retailer takes title to a good only momentarily before the supplier ships the good to a customer. However, if the customer were to be dissatisfied with the good, the customer would return it to the online retailer rather than the supplier. The online retailer would then have back-end inventory risk since it would have to determine whether it can resell the good to another customer or return the good to the supplier.

**10.2.4.3 Discretion in Establishing Pricing**

When an entity has control over the establishment of pricing, it generally assumes substantial risks and rewards related to the demand of the specified product or service, especially when the price it is required to pay a third party for the specified good or service is fixed. In contrast, when an entity acts as an agent in a transaction, the amount that the entity earns may be fixed (either in absolute dollars per transaction or as a fixed percentage of the sales price).

When combined with other factors, pricing discretion could indicate that the entity controls the specified good or service before it is transferred to the customer. However, ASC 606-10-55-39(c) states that “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.”

**Example 10-5**

A food delivery service offers delivery of meals from restaurants to customers within a one-mile radius from a specific location in a city. Via its Web site, the food delivery service connects a customer with a restaurant and also delivers ordered food from the restaurant to the customer. Each restaurant indicates its prices on the food delivery service's Web site and has the ability to change those prices daily. The food delivery service earns a 5 percent commission on sales from each restaurant order.

In this example, each restaurant has discretion in establishing pricing rather than the food delivery service. This would suggest that the restaurant controls the specified good or service (i.e., the food ordered by the customer) at all times before the food is transferred to the customer.

Note, however, that the food delivery service may be the principal for the delivery service, in which case it would be an agent for part of the transaction and a principal for another part. Refer to Section 10.4 for further discussion of contracts in which an entity is both a principal and an agent.

**10.2.5 Other Indicators**

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 in the legacy guidance of ASC 605-45 were included in ASC 606 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.

10.2.6   Codification Examples of Promised Goods or Services for Which an Entity Is a Principal (ASC 606-10-55-320 Through 55-329)

The following implementation guidance from the new revenue standard will help an entity determine whether it is acting as a principal in a contract:

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<th>ASC 606-10</th>
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**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.

- Subparagraph superseded by Accounting Standards Update No. 2016-08.
- Subparagraph superseded by Accounting Standards Update No. 2016-08.
- Subparagraph superseded by Accounting Standards Update No. 2016-08.
- Subparagraph superseded by Accounting Standards Update No. 2016-08.
- Subparagraph superseded by Accounting Standards Update No. 2016-08.

**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 fulfillment 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:

a. Subparagraph superseded by Accounting Standards Update No. 2016-08.

b. Subparagraph superseded by Accounting Standards Update No. 2016-08.

c. Subparagraph superseded by Accounting Standards Update No. 2016-08.

d. Subparagraph superseded by Accounting Standards Update No. 2016-08.

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.
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.

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.

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.

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 (i.e., the net amount of consideration retained) 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:

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.
10.3.1 Codification Examples of Promised Goods or Services for Which an Entity Is an Agent (ASC 606-10-55-317 Through 55-319 and ASC 606-10-55-330 Through 55-334)

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.

**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.

- Subparagraph superseded by Accounting Standards Update No. 2016-08.
- Subparagraph superseded by Accounting Standards Update No. 2016-08.
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- Subparagraph superseded by Accounting Standards Update No. 2016-08.
- Subparagraph superseded by Accounting Standards Update No. 2016-08.

**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.

- 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.
- 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.
- The entity does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.
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.

Example 48 — Arranging for the Provision of Goods or Services (Entity Is an Agent)

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.

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.

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.

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.

a. Subparagraph superseded by Accounting Standards Update No. 2016-08.

b. Subparagraph superseded by Accounting Standards Update No. 2016-08.

c. Subparagraph superseded by Accounting Standards Update No. 2016-08.

d. Subparagraph superseded by Accounting Standards Update No. 2016-08.

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.

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).

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.
10.3.2 Timing of Revenue Recognition When the Entity Is an Agent

The timing of when an agent satisfies its performance obligation may not be the same as the timing of when the principal in the arrangement transfers control of the specified good or service to the end customer. As noted in Section 8.2, ASC 606-10-25-23 states that (1) an entity should “recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service . . . to a customer” and (2) an “asset is transferred when (or as) the customer obtains control of that asset.” Accordingly, when an entity determines that it is acting as an agent with respect to the specified good or service, the entity must use judgment and consider all of the relevant facts and circumstances to determine when it has satisfied its performance obligation to arrange for the provision of a specified good or service by another party.

10.4 Contracts in Which the Entity Is a Principal and an Agent

As discussed in Section 10.1.1, an entity must determine whether it is a principal or an agent at what can effectively be described as the performance obligation level (i.e., the specified good or service that is distinct), 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).

10.4.1 Illustrative Examples of Contracts in Which an Entity Is Both a Principal and an Agent

The following implementation guidance from the new revenue standard illustrates a situation in which an entity is a principal and an agent in the same contract:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
</table>

**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.
Chapter 10 — Principal-Versus-Agent Considerations

ASC 606-10 (continued)

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 database access to be provided to the customer. If this is not the case (e.g., because the entity would be responsible for the acceptability of the database access), the analysis could be different.

Example 10-6

Company X, a food delivery service, offers delivery of meals from restaurants to customers within a one-mile radius from a specific location in a city. Via its Web site, the food delivery service connects a customer with a restaurant, processes food orders, and provides a service of delivering food to the customer. Each restaurant has full discretion to establish the price for its food ordered through X. The food delivery service earns a 5 percent commission on sales from each restaurant order and charges a flat delivery fee of $5 per order. Company X can change the delivery fee at its discretion. Company X takes custody of the food ordered from a restaurant, but it can deliver the food only to the customer's location. The restaurant is responsible for addressing all customer complaints regarding the quality of the food or an incorrect order. If the food is compromised while in transit, X is liable. Assume that the food and the delivery service are each capable of being distinct and distinct within the context of the contract (see Chapter 5).

In this example, X does not obtain control of the food (one of the specified goods or services) before it is transferred to the customer. Although X takes custody of the food, it cannot redirect the food to another customer or consume the good (the food) as a resource. Further, X is not responsible for addressing customer complaints, does not purchase the food before the food is transferred to the customer, and does not have discretion to establish the price of the food. Company X is acting as an agent and arranging for the restaurant to fulfill the promise to transfer food to the customer.

However, X is primarily responsible for providing the service of delivering the food to the customer. If the food is compromised while in transit, X is liable to the customer. Further, X has full discretion to establish the price of the delivery service. Consequently, X is the principal for the delivery service.
10.4.2 Allocating the Transaction Price When an Entity Is a Principal for Some Performance Obligations and an Agent for Other Performance Obligations

In a single contract, an entity may promise to (1) arrange for goods or services to be provided by another entity (i.e., the entity is acting as an agent) and (2) transfer goods or services to the customer itself (i.e., the entity is acting as a principal). As a result, the entity may identify one or more performance obligations for which it is acting as an agent and one or more performance obligations for which it is acting as a principal in the same contract. In such a situation, an entity must consider how to allocate the contract transaction price to those separate performance obligations.

ASC 606-10-32-28 states the objective of allocating the transaction price:

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.

ASC 606-10-32-29 explains how to meet this objective:

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).

Further, ASC 606-10-32-36 states:

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.

In light of the guidance above, we believe that an entity should generally allocate the transaction price to all of the performance obligations (i.e., those for which the entity is acting as a principal as well as those for which the entity is acting as an agent) on a relative stand-alone selling price basis. When allocating the transaction price, the entity should also consider the guidance on allocating discounts and variable consideration to individual performance obligations. In addition, given the guidance above, we believe that there are two acceptable models (“Alternative A” and “Alternative B”) for allocating a contract transaction price when the entity is a principal for some performance obligations and an agent for other performance obligations. Those models are illustrated in Example 10-7 below.
Example 10-7

Entity X sells two distinct products, Item 1 and Item 2, and provides a distinct service to Customer Z for a total contract price of $180,000. The products and the service are all transferred to the customer at different times. The stand-alone selling prices are as follows:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Stand-Alone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item 1</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Item 2</td>
<td>50,000</td>
</tr>
<tr>
<td>Service</td>
<td>60,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 210,000</td>
</tr>
</tbody>
</table>

Entity X determines that it is the principal for the sale of Item 1 and Item 2 but that it is an agent for the service. Entity X agrees to sell the service for $60,000 on behalf of a third-party service provider for a 25 percent commission and bundles the service with its products. Thus, $45,000 is remitted to the third-party service provider, and X retains a $15,000 commission. Assume that the criteria for allocating a discount to one or more, but not all, performance obligations in accordance with ASC 606-10-32-37 are not met.

**Alternative A**

Entity X determines that the stand-alone selling price of the service provided as an agent is $15,000 (and that therefore, the total stand-alone price of the performance obligations is $165,000). Because X must remit $45,000 back to the third-party service provider and retains only a $15,000 commission, X determines that the total consideration it is entitled to receive is $135,000 rather than the contract price of $180,000. Therefore, X allocates the $135,000 transaction price to Item 1, Item 2, and the service on a relative stand-alone selling price basis, as shown in the table below:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Allocated Transaction Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item 1</td>
<td>$81,818 ($100,000 ÷ $165,000 total stand-alone selling price) × $135,000)</td>
</tr>
<tr>
<td>Item 2</td>
<td>$40,909 ($50,000 ÷ $165,000 total stand-alone selling price) × $135,000)</td>
</tr>
<tr>
<td>Service</td>
<td>$12,273 ($15,000 ÷ $165,000 total stand-alone selling price) × $135,000)</td>
</tr>
</tbody>
</table>
Example 10-7 (continued)

**Alternative B**

The facts and circumstances in this example may suggest that X’s performance obligations are provided to two separate customers (i.e., the facts and circumstances may support a determination that those performance obligations for which X acts as a principal (Item 1 and Item 2) are transferred to the end customer, and the performance obligation for which X acts as an agent (arranging for the service to be provided by the third party) is performed on behalf of the third party). If so, we believe that it is acceptable for X to (1) allocate $120,000 ($180,000 contract price – $60,000 stand-alone selling price of the service) to Item 1 and Item 2 on a relative stand-alone selling price basis and (2) allocate the $15,000 commission received from the third-party service provider directly to the service. The allocations are shown in the table below.

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Allocated Transaction Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item 1</td>
<td>$80,000 ($100,000 ÷ $150,000 total stand-alone selling price of A and B) × $120,000)</td>
</tr>
<tr>
<td>Item 2</td>
<td>$40,000 ($50,000 ÷ $150,000 total stand-alone selling price of A and B) × $120,000)</td>
</tr>
<tr>
<td>Service</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

While both alternatives described in Example 10-7 above are acceptable, we believe that for an entity to fairly depict the substance of the transaction, one alternative may be preferable to the other depending on the facts and circumstances of the particular arrangement. To determine which alternative is preferable, an entity should understand and evaluate the relationship of all of the parties involved in the particular arrangement. Specifically, Alternative A would most likely be preferable if (1) the facts and circumstances indicate that the entity has only one customer in the arrangement or (2) the economic substance of the arrangement is such that there is a single bundled discount provided to the end customer. In contrast, Alternative B would most likely be preferable if the facts and circumstances indicate that (1) the entity's performance obligations in the contract (or contracts) are provided to two separate customers (i.e., those performance obligations for which the entity acts as a principal are transferred to the end customer, and those performance obligations for which the entity acts as an agent are performed on behalf of a third party) and (2) the pricing of the performance obligations provided to the separate customers is not interdependent.

### 10.5 Other Considerations

#### 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).
Chapter 10 — Principal-Versus-Agent Considerations

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 that permits entities to exclude from the total gross receipts 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. See Chapter 15 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 legacy 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.

1 The IASB did not amend IFRS 15 for this practical expedient. For a summary of differences between U.S. GAAP and IFRS Standards, see Appendix A.
10.5.3 Income Tax Withholdings

Example 10-8 below illustrates how an entity that acts as a principal to provide services to a customer would account for income tax that the customer withholds and remits to the customer’s local government on behalf of the entity providing the services.

Example 10-8

Company X performs consulting services for Company C, which is located in a country other than that of X. Company C owes a $100 fee to X for performing the consulting services and withholds 20 percent of the fee as a local income tax withholding. Company C 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.

Company X is the principal in providing the consulting services to C (i.e., there are no third parties involved in providing the services). 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 (i.e., X should not report net revenue of $80).

Company X is not eligible for the practical expedient in ASC 606-10-32-2A in this instance because the amount being withheld is 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 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. Shipping costs may also be costs incurred directly by the seller (e.g., salaries and overhead related to the activities needed 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 inventory 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.

ASU 2016-10 provides a practical expedient that permits shipping and handling costs that occur after control of the promised goods or services is transferred to the customer to be presented as fulfillment costs. That is, shipping and handling does not need to be identified as a promised good or service and a potential performance obligation. ASC 606-10-25-18B (added by ASU 2016-10) states:

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.
If an entity does not avail itself of the aforementioned practical expedient, 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 is transferred on receipt by the customer (e.g., on “free on board” destination), the vendor will generally be considered to be the principal with respect to the shipping and handling services. If, however, control of the goods is transferred when the goods are shipped, the vendor will need to determine whether it is the principal or the agent with respect to the shipping service.

If, after consideration of the requirements in ASC 606-10-55-36 through 55-40, the vendor determines that it is responsible for shipping and handling as a principal, 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 the vendor 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, the vendor should not report the amount charged by that third party for shipping as its own revenue. Instead, the vendor should report as revenue only the commission it has received (if any) for arranging shipping, which is the excess of (1) any amounts the vendor charged the customer for shipping services over (2) any amounts paid to the third party for those services.

### 10.5.5 Revenue Equal to Costs

An entity may determine, in accordance with ASC 606-10-55-36 through 55-40, that it provides goods, services, or both as a principal. In addition, the entity may sell some goods and services to third parties at an amount equal to the cost of the goods and services.

In these circumstances, the entity is not permitted to present the associated revenues and expenses on a net basis. When an entity has determined 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 Section 10.5.7.

### 10.5.6 Royalty Considerations

Example 10-9 below considers whether an entity that acts as a principal should (1) offset the royalties it pays a third party to fulfill a contract with a customer against revenue received from the customer or (2) recognize the royalty payments as a cost of fulfilling the contract with the customer.

#### Example 10-9

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 B).

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 13.

## 10.5.7 Shared Commissions

Example 10-10 below considers whether an entity may offset expenses against revenue from shared commissions.

**Example 10-10**

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.

Company A is **not** permitted to offset the amount it pays to the financial advisers against the commission revenue it receives from the insurance company. Because A is acting as a principal in providing services to the insurance company and not as an agent for the financial advisers, 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 and 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, in part:

> 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 — Customer Options for Additional Goods or Services (Material Rights)

11.1 In General
11.2 Determining Whether an Option for Additional Goods or Services Represents a Material Right
11.3 Optional Purchases Versus Variable Consideration
11.4 Likelihood That an Option for Additional Goods or Services Will Be Exercised
11.5 Allocation of Consideration to Material Rights
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11.8 Vouchers, Discounts, and Coupons
11.9 Renewal Options
11.10 Recognition of Revenue Related to Options That Do Not Expire
11.11 Amortization Period of Material Rights
11.1 In General

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**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. Options for additional goods or services 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 (1) a customer’s payment of a nonrefundable up-front fee and (2) 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.

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 legacy 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 legacy 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 of 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 legacy 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 legacy "significant and incremental" guidance because the boards specifically did not carry forward the language in legacy 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 legacy 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) a consumable used in Product X at a price of $30. In addition, the contract contains an option that allows the customer to buy additional consumables at a price of $30 each. The stand-alone selling price for Product X is $200, and the stand-alone selling price for each consumable for this class of customer is $60.

Under ASC 606, the customer's option to purchase consumables for $30 each would reflect a material right because a 50 percent discount ($30 contract price per consumable ÷ $60 stand-alone selling price per consumable) is incremental to the range of discounts typically given for those goods to that class of customer in that market. That is, the discount is incremental to the range of discounts typically given in comparable contracts, as indicated by the comparison of the goods' discount price under the contract with their stand-alone selling price.

However, under legacy U.S. GAAP, if Product X was software, a 50 percent discount on the consumables 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 consumables is not incremental to the 50 percent discount given on Product X ($100 contract price ÷ $200 stand-alone selling price) or on the first consumable ($30 contract price ÷ $60 stand-alone selling price). Therefore, under legacy software revenue guidance, the entity would not account for the offer of a discount on the consumables as a separate element.
11.2 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.

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\(^1\)) and (2) assess both quantitative and qualitative factors. Further, 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, get one free,” 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.

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. In accordance with ASC 606-10-25-16B, entities should not apply the

\(^1\) ASC 606-10-25-2 and ASC 606-10-55-42.
guidance in ASC 606-10-25-16A on assessing whether promises for immaterial goods or services are performance obligations to the assessment of whether a contract option provides 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).

An entity should consider its customer's reasonable 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 (Section 11.8), 50 (Section 11.2), 51 (Section 11.9), and 52 (Section 11.2.2) in ASC 606-10-55-336 through 55-356 for illustrations of how an entity would determine whether an option provides a customer with a material right. In addition, some industries, such as the software industry, more commonly provide customers with options to purchase additional goods or services. Refer to Sections 12.3.3.1 and 12.6.3.2 for examples of how an entity would assess whether options to purchase additional copies of software or options to renew postcontract customer support (PCS) provide a customer with a material right.

The above issue is addressed in Q&As 12 through 14 (compiled from previously issued TRG Agenda Papers 6, 11, 54, and 55) of the FASB staff's Revenue Recognition Implementation Q&As (the “Implementation Q&As”). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

11.2.1 Need for Assessing Whether a Material Right Exists When the Residual Approach Was Used to Establish the Stand-Alone Selling Price of the Additional Goods or Services

Determining the stand-alone selling price of goods or services offered to a customer under a contract option is a necessary step in the assessment of whether a material right exists. The ability to sell certain goods or services for a wide range of prices may make it difficult to establish the stand-alone selling price of goods or services offered to a customer under a contract option (e.g., a renewal option). This is especially true in the software industry, in which the incremental costs incurred to sell additional software licenses are often minimal and therefore allow software entities to sell their software at prices spanning a wide range of discounts or even premiums. Consequently, the FASB included the residual approach in ASC 606 as a “suitable” method for establishing the stand-alone selling price.

If an entity applied the residual approach to establish the stand-alone selling price of goods or services because the stand-alone selling price of those goods or services is highly variable or uncertain, the entity is required to assess whether an option (e.g., a renewal option) to acquire more of those goods or services conveys a material right to the customer. Under ASC 606-10-55-41 through 55-45, a customer option to purchase additional goods or services gives rise to a material right if the option provides the entity's customer with a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer (e.g., a customer in a particular geographical area or market). It would not be appropriate for the entity to conclude that no material right was conveyed to the customer simply because the stand-alone selling price of the goods or services that are subject to the option is highly variable or uncertain and the residual approach was therefore applied.
When the residual approach is used to determine the stand-alone selling price of a good or service because pricing is highly variable or uncertain, an entity may need to use significant judgment when assessing whether option pricing for that good or service provides a material right because of the lack of a point estimate or sufficiently consistent range representing the stand-alone selling price. While we believe that entities are likely to identify fewer material rights in such cases, they are nonetheless required to base their determination of whether a material right was provided on all reasonably available information. Although the presence of highly variable or uncertain pricing complicates the identification of material rights, we believe that when doing so, an entity should consider (1) the definition of a material right\(^2\) and (2) the allocation objective in ASC 606-10-32-28. In other words, an entity must determine whether the pricing of the optional good or service (1) indicates that preferential pricing would not have been received “but for” the initial contract or (2) reflects the amount to which the entity expects to be entitled in exchange for transferring that good or service to the customer. If the pricing does not meet the allocation objective (i.e., it is a discount that is incremental to what other similar customers would receive), a material right should be identified. We believe that an entity might find the following factors useful in determining whether a material right is present when the pricing of optional future purchases is highly variable or uncertain:

- **How the pricing of the optional future purchase aligns with current pricing policies and practices** — For example, if a good or service is not typically sold below a certain amount because it is a premium offering, an option to buy the good or service at an amount below that floor would be at odds with standard pricing practices and may therefore convey a material right to the customer.

- **How the pricing of the optional future purchase compares to historical amounts allocated to the good or service in similar situations** — Such a comparison is likely to require an entity to look to historical data and stand-alone selling prices that were derived by using the residual approach. Accordingly, while there will not be an established point estimate or narrow range of stand-alone selling prices against which to compare the pricing of the optional future purchase, ASC 606-10-32-34(c) indicates that the residual approach is a method of establishing a stand-alone selling price. Therefore, the amounts determined under that approach represent the stand-alone selling price for that good or service. Consequently, we believe that in assessing whether a customer has been given a material right, an entity may obtain useful information by comparing the pricing of an optional future purchase with historical stand-alone selling prices that were determined as a result of applying the residual approach. In addition, to determine which range of historical stand-alone selling prices to compare with the pricing of the optional future purchase, entities should consider only those transactions that are similar to the transaction in question. For example, an entity might disaggregate historical stand-alone selling price data by one or more of the following characteristics: class of customer, geography, distribution channel, or contract value.

- **How the pricing of the optional future purchase compares to historical contractually stated pricing (if any) of the good or service in similar situations** — While the contractually stated pricing may not represent the stand-alone selling price (see ASC 606-10-32-32), it may be indicative of an entity’s pricing practices and discounts it may offer on future purchases.

- **Whether the pricing of the optional future purchase is intended to incorporate a discount** — If the intent during negotiations was to give the customer a discount on future purchases, a material right may exist since the allocation objective is less likely to be met in such cases. For example, a customer may only have agreed to enter into an initial contract if the vendor offered discounted pricing on future purchases.

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\(^2\) A material right arises from pricing on an option to acquire additional goods or services in the future that would not have been received if the initial contract had not been entered into. In such cases, the customer with the option has essentially prepaid for the future purchase.
• Whether the pricing of the optional future purchase is discounted relative to (1) the price of similar goods or services sold under the initial contract or (2) the list price when compared with the discounted list prices of all goods or services (whether similar or not) sold under the initial contract — We acknowledge that this factor conflicts with the FASB’s reasons for departing from its definition of a significant incremental discount in legacy GAAP under ASC 985-605. In paragraph BC387 of ASU 2014-09, the Board indicates its rationale for defining “incremental” solely by reference to other comparable transactions:

[T]he Boards observed 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. Consequently, the Boards decided not to carry forward that part of the previous revenue recognition guidance from U.S. GAAP into Topic 606.

However, we believe that when evaluated in conjunction with all other available evidence, a comparison of the pricing of the optional future purchase with any discounts offered in the initial contract may provide insight into an entity’s pricing practices and discounting intentions.

• How the pricing of the optional future purchase aligns with any intended future pricing for similar goods or services — For example, an option to buy add-on software at a set price may not give the customer a material right if that price approximates the amount at which management intends to sell that software on a stand-alone basis in the near future.

• The relative negotiating power of the entity and the customer — In certain situations, customers may have a greater ability to demand discounted pricing on optional future purchases if the customers represent significantly larger, well-known brands that are dominant in their markets, are more mature, or are otherwise better positioned than the entity selling the goods or services.

The above factors are not intended to be all-inclusive or prescriptive, and each factor on its own may not be determinative. Entities may need to use significant judgment when determining whether a material right has been granted. Entities with highly variable or uncertain pricing should establish a policy for evaluating material rights and apply that policy consistently in similar situations.

The examples below demonstrate the application of some of the concepts described above.

**Example 11-1**

Entity J, an early-stage software developer, enters into an arrangement with Customer T, a large U.S.-based company, to license its software on a term basis and provide PCS for one year. The arrangement also includes hardware and professional services. The total transaction price is $2 million, and J has established that the license, PCS, hardware, and professional services each represent a distinct performance obligation.

Entity J has concluded that the pricing of software licenses is highly variable and uses the residual approach to determine the stand-alone selling price. The observable stand-alone selling prices of the other performance obligations are as follows:

- **PCS** — $200,000.
- **Professional services** — $500,000.
- **Hardware** — $300,000.

Under the residual approach, $1 million is allocated to the software license, which J determines is consistent with the allocation objective. The contract also indicates that the customer may renew the software license for $250,000 per additional year and that the pricing for other products and services will be at their stand-alone selling prices.
Example 11-1 (continued)

Entity J reviews historical transaction data for sales of software licenses to large customers in the United States to determine the amounts that have been allocated to the software license under the residual approach. Over the past year, a range of $500,000 to $3 million has been allocated to the software license, which is consistent with J's pricing policies. While J did not initially intend to give T a discount, it was willing to negotiate on renewal pricing because it wanted to secure the large contract and is able to enhance the marketability of its products by obtaining T as a customer (T is a well-known brand and dominant in its market). Therefore, J concludes that the pricing of the optional future purchase has given T a material right.

We believe that the following factors indicate that T has received a material right:

- A comparison of (1) the price T must pay if it exercises its option to renew the license in the future ($250,000) and (2) the range of stand-alone selling prices determined under the residual approach in similar historical transactions ($500,000 to $3 million) indicates that the pricing offered to T does not meet the allocation objective because T is receiving a significant discount that is incremental to the range of discounts offered to other similar customers.
- Although J did not initially intend to give T a discount on future purchases, other facts and circumstances indicate that J nonetheless offered T preferential pricing.

Example 11-2

Entity A enters into an arrangement with Customer C, a midsized company based in Europe, to license its software on a term basis and provide PCS for one year. The arrangement also includes hardware and professional services. The total transaction price is $20,000, and A has established that the license, PCS, hardware, and professional services each represent a distinct performance obligation.

Entity A has concluded that the pricing of software licenses is highly variable and uses the residual approach to determine the stand-alone selling price. It has observable stand-alone selling prices for its other products and services. The list price, contractually stated price, discount from list price, and stand-alone selling price of each performance obligation are as follows:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>List Price</th>
<th>Contractually Stated Price</th>
<th>Discount From List Price</th>
<th>SSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$ 7,500</td>
<td>$ 4,500</td>
<td>40%</td>
<td>$ 5,000*</td>
</tr>
<tr>
<td>PCS</td>
<td>$ 3,500</td>
<td>$ 3,500</td>
<td>0%</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Professional services</td>
<td>$ 8,000</td>
<td>$ 5,000</td>
<td>38%</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Hardware</td>
<td>$ 10,000</td>
<td>$ 7,000</td>
<td>30%</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 29,000</td>
<td>$ 20,000</td>
<td>31%</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

* Determined under the residual approach on the basis of a total transaction price of $20,000 minus the sum of the observable SSPs of the other performance obligations ($3,000 + $6,000 + $6,000 = $15,000).

The contract also indicates that the customer may renew the software license for $3,000 per additional year, which represents a 60 percent discount from the list price, and that the pricing for other products and services remains at the same contractually stated prices.

Entity A reviews historical transaction data for sales of software licenses to midsized customers in Europe to determine the contractually stated prices and related discounts from list price for the software license. Over the past year, the software license has been priced between $1,000 to $20,000, thus ranging from a discount of 87 percent to a premium of 167 percent relative to the list price. Entity A's internal pricing policies require that discounts of over 50 percent must undergo an extensive approval process. Further, A intended to give C a discount on renewals of the software license because A is in a highly competitive market in which customer retention is difficult. In addition, C indicated that it would purchase large additional amounts of hardware. Therefore, A concludes that the pricing of the optional future purchase(s) gives C a material right.
Example 11-2 (continued)

We believe that the following factors indicate that C has received a material right:

- It is not especially meaningful to compare (1) the discount to the list price C receives if it exercises its option to renew the license in the future (60 percent) with (2) the range of discounts and premiums in similar historical transactions (87 percent discount to 167 percent premium) given the significant pricing variation observed in the data. However, A's internal pricing policies require any discounts of over 50 percent undergo an extensive approval process.

- On the basis of a comparison of (1) the discount from list price for the renewal pricing (60 percent) with (2) the other discounts offered in the same contract (0 percent to 38 percent for other goods and services and 40 percent for the same software license), A determines that the optional future purchase pricing conveys an incremental discount to C that it did not receive under the initial contract.

- Entity A's intention to give C a discount to secure its future business in a competitive market supports a conclusion that “but for the initial contract,” C would not have received favorable pricing on future software license renewals.

- Customer C's indication that it would make many additional purchases of hardware supports A's decision to provide preferential pricing.

11.2.2 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 \([100,000 \times (100,000 \text{ standalone selling price ÷ } 109,500)]\) |
| Points  | $8,676 \([100,000 \times (9,500 \text{ standalone selling price ÷ } 109,500)]\) |

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 \([(4,500 \text{ points } + 9,500 \text{ points}) \times 8,676\)] 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 \([(8,500 \text{ total points redeemed } + 9,700 \text{ total points expected to be redeemed}) \times 8,676 \text{ initial allocation}] - $4,110 \text{ recognized in the first reporting period}\) for the unredeemed points at the end of the first reporting period.

The contract liability balance is $1,073 \(8,676 \text{ initial allocation } - 7,603 \text{ of cumulative revenue recognized}\).
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.

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.

In circumstances in which a customer’s loyalty points accumulate with each transaction, 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 above issue is addressed in Implementation Q&A 12 (compiled from previously issued TRG Agenda Papers 6 and 11). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

Note that the above discussion focuses on loyalty programs in which points that a customer has earned by purchasing goods or services from a vendor are redeemed for future goods or services from the same vendor. For loyalty programs in which accumulated points can be redeemed for goods or services from a third party or for goods or services from the original vendor that meet the requirement to be a separate performance obligation, the original vendor should evaluate upon redemption whether it is acting as a principal or as an agent in the transaction associated with the deferred recognition of revenue. (See Chapter 10 for additional considerations related to the assessment of whether an entity is a principal or an agent.) For example, suppose that Company X, an airline, offers one point for every $100 a customer spends. The accumulated points can be redeemed for either future flights provided by X or future hotel stays with Hotel Y, a vendor with which X has partnered. Since X has determined that its loyalty programs offer a material right that is a performance obligation, X defers a portion of revenue for the redemption of the loyalty points. Upon a customer’s redemption of points for either a flight or a hotel stay, X evaluates whether it is acting as a principal or as an agent in that transaction.

Further, any changes to an entity’s incentives (e.g., loyalty programs, rebates, method of redeeming points, amounts for which points are earned) should be evaluated under the contract modification guidance discussed in Chapter 9.
11.2.3 Considering the Class of Customer in the Evaluation of Whether a Customer Option Gives Rise to a Material Right

As noted in Section 11.2.2, when determining whether a material right exists, an 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. Implementation Q&A 14 (compiled from previously issued TRG Agenda Papers 54 and 55) and TRG Agenda Paper 54 provide the following examples of the FASB staff's views on this topic:

<table>
<thead>
<tr>
<th>Example</th>
<th>Facts</th>
<th>FASB Staff Analysis and Views</th>
</tr>
</thead>
</table>
| 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>
<thead>
<tr>
<th>Example</th>
<th>Facts</th>
<th>FASB Staff Analysis and Views</th>
</tr>
</thead>
</table>
| 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 affect the conclusion in each fact pattern." 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.

TRG members debated the application of concepts in the framework the staff used to analyze the examples in Implementation Q&A 14 and 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).

Following its stakeholder outreach, the FASB staff indicated that an entity should evaluate whether tier status programs contain material rights or represent a marketing incentive. In making this evaluation, the FASB staff indicated that entities should consider whether discounts offered on future goods or services to customers within a given tier of a status program are incremental to the range of discounts typically given to that class of customer. If an entity never provides customers with tier status other than through past purchases, the discounts provided to customers under the program are likely to be material rights. However, if an entity sometimes provides tier status to customers for reasons other than past purchases, the discounts may be marketing incentives provided to a particular class of customer. The determination of whether discounts under a tier status program are material rights or marketing incentives will require judgment based on an evaluation of the specific facts and circumstances of the specific program.

3 Quoted from Implementation Q&A 14.
11.3 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 (which the entity would need to evaluate to determine whether a material right — and, therefore, a separate performance obligation — exists) and variable consideration in the transaction price that is driven by variable volumes (i.e., the additional volumes are part of a single performance obligation). 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 to buy additional distinct goods or services (or change the goods or services to be delivered) 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 customer's own actions) will not obligate the vendor to provide additional distinct goods or services (or change the goods or services to be delivered), any additional consideration triggered by those events would instead be variable consideration.

Section 6.3.5.4.1 discusses considerations related to an entity's determination of whether a contract contains optional purchases or variable consideration. Further, Section 12.3.3 discusses optional purchases in a licensing scenario.

11.4 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).

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.

In such circumstances, when it is highly probable, or even virtually certain, that the customer will exercise its option, the additional goods or services should not be treated as performance obligations under the contract. 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 withASC 606-10-55-41 through 55-45) to determine whether it gives rise to a material right.
Chapter 11 — Customer Options for Additional Goods or Services (Material Rights)

The above issue is addressed in Implementation Q&A 21 (compiled from previously issued TRG Agenda Papers 48 and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

11.5 Allocation of Consideration to Material Rights

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
</table>
| **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. |

If an entity’s contract with a customer includes a material right in the form of an option to acquire additional goods or services, ASC 606-10-55-41 through 55-45 require the 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. The allocation of consideration to all of the performance obligations in a contract as required in step 4 is performed 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. In addition, ASC 606-10-55-45 provides an alternative to estimating the stand-alone selling price of a customer option when certain criteria are met (discussed in Section 11.9). Allocation of the transaction price in step 4 is discussed comprehensively in Chapter 7.

11.6 Whether There Can Be a Significant Financing Component as a Result of a Material Right

If an entity’s contract with a customer includes a material right in the form of a customer option for additional goods or services, the entity should evaluate whether there is a significant financing component as a result of the option in accordance with ASC 606-10-32-17 and 32-18. A significant financing component would not exist if, for example, the timing of transfer of additional goods or services is at the customer’s discretion. In some circumstances, the practical expedient in ASC 606-10-32-18 may be available.
Example 11-3

Entity C enters into a contract with a customer under which the customer will receive Product W immediately and will have the option to purchase Product X five years later. The customer does not have the discretion to choose when to exercise the option; rather, the customer can exercise the option only at the point in time that is five years after its purchase of Product W. Under the contract, the customer is required to pay $340 at the outset and an additional $300 five years later if it chooses to exercise the option.

The stand-alone selling prices of Product W and Product X are $200 and $600, respectively. Entity C concludes that the option to purchase Product X provides the customer with a material right. However, because the customer pays for the material right at the outset but can exercise the option only five years later, C also concludes that the contract includes a financing component, which it judges to be significant. Assume C determines that the present value of the stand-alone selling price of the option is $155, which it calculates by using a 10 percent interest rate based on the rate that would be used in a separate financing transaction between C and the customer and an approximate 85 percent likelihood that the option will be exercised.

The entity allocates the $340 transaction price between Product W and the option as follows:

<table>
<thead>
<tr>
<th>Transaction Price ($)</th>
<th>Stand-Alone Selling Price ($)</th>
<th>% Allocation</th>
<th>Allocation ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product W</td>
<td>200</td>
<td>56.3%</td>
<td>192</td>
</tr>
<tr>
<td>Option</td>
<td>155</td>
<td>43.7%</td>
<td>148</td>
</tr>
<tr>
<td>Total</td>
<td>340</td>
<td>100.0%</td>
<td>340</td>
</tr>
</tbody>
</table>

Accordingly, the entity (1) recognizes revenue of $192 when Product W is delivered and (2) recognizes a contract liability of $148 related to the material right.

Each year, the entity records interest expense related to the financing component of the material right at the rate of 10 percent as follows:

<table>
<thead>
<tr>
<th>Opening Balance ($)</th>
<th>Interest Expense ($)</th>
<th>Closing Balance ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>148</td>
<td>15</td>
</tr>
<tr>
<td>Year 2</td>
<td>163</td>
<td>16</td>
</tr>
<tr>
<td>Year 3</td>
<td>179</td>
<td>18</td>
</tr>
<tr>
<td>Year 4</td>
<td>197</td>
<td>20</td>
</tr>
<tr>
<td>Year 5</td>
<td>217</td>
<td>22</td>
</tr>
</tbody>
</table>

Accordingly, over the five-year period, the entity recognizes total interest expense of $91. This is added to the price initially allocated to the option of $148, resulting in a closing balance of $239 at the end of year 5.

At the end of year 5, the customer exercises the option and pays an additional $300. The entity applies the “Alternative A” approach described in Section 11.7 and allocates to Product X the balance of the material right ($239) and the additional $300 paid. Therefore, it recognizes revenue of $539 when Product X is delivered.
**Example 11-3 (continued)**

Accordingly, C records the following journal entries in each year of the contract:

**At contract inception, to recognize revenue for the transfer of Product W and establish the contract liability for the customer's option to purchase Product X in five years:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Cash</th>
<th>Revenue</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>At contract inception</td>
<td>340</td>
<td>192</td>
<td>148</td>
</tr>
</tbody>
</table>

**At the end of year 1, to recognize interest expense related to the financing component of the material right:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest expense</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the end of year 1</td>
<td>15</td>
<td>15</td>
</tr>
</tbody>
</table>

**At the end of year 2, to recognize interest expense related to the financing component of the material right:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest expense</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the end of year 2</td>
<td>16</td>
<td>16</td>
</tr>
</tbody>
</table>

**At the end of year 3, to recognize interest expense related to the financing component of the material right:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest expense</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the end of year 3</td>
<td>18</td>
<td>18</td>
</tr>
</tbody>
</table>

**At the end of year 4, to recognize interest expense related to the financing component of the material right:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest expense</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the end of year 4</td>
<td>20</td>
<td>20</td>
</tr>
</tbody>
</table>

**At the end of year 5, to recognize interest expense related to the financing component of the material right:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest expense</th>
<th>Contract liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the end of year 5</td>
<td>22</td>
<td>22</td>
</tr>
</tbody>
</table>

**At the end of year 5, to recognize revenue upon the customer's exercise of the option to purchase Product X:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Cash</th>
<th>Contract liability</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the end of year 5</td>
<td>300</td>
<td>239</td>
<td>539</td>
</tr>
</tbody>
</table>

The above issue is addressed in Implementation Q&A 35 (compiled from previously issued TRG Agenda Papers 18, 25, 32, and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.
11.7 Customer’s Exercise of 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, an entity may account for the customer’s subsequent exercise of the material right either as if it were a separate contract ("Alternative A," which we generally believe is preferable) or as if it were the modification of an existing contract ("Alternative B," which we believe is acceptable). Those alternatives may be summarized as follows:

- **Alternative A (preferred)** — At the time a customer exercises a material right, an entity treats the exercise as a continuation of the original contract such that the additional consideration is allocated only to the additional performance obligation underlying the material right. In effect, therefore, the entity is treating the exercise as if it were a separate contract altogether. Under this alternative, an entity should determine the transaction price of the “new” contract and include any additional consideration to which the entity expects to be entitled as a result of the exercise. This additional consideration, along with the consideration from the original contract that was allocated to the material right, 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 as part of the original contract is added to any additional amounts due (under the “new” contract) as a consequence of the customer’s exercise of the material right, and that total is allocated to the additional goods or services under the “new” contract. The amounts previously allocated to the other goods and services in the original contract are not revised.

- **Alternative B (acceptable)** — It is also acceptable to account for the exercise of a material right as a contract modification since it results in a change in the scope and the price of the original contract. An entity should apply the modification guidance in ASC 606-10-25-10 through 25-13. Since we believe that the application of Alternative B may be complex, we recommend that entities consider consulting with their accounting advisers before electing to use this method.

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 such that the additional consideration would be allocated to the performance obligation underlying the material right and would be recognized when or as the performance obligation underlying the material right is satisfied. This, in effect, results in accounting for the exercise of a material right as a separate contract. 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 (which may require reallocation of consideration between existing and future performance obligations). Contract modifications are discussed in Chapter 9.

The method used should be applied consistently by an entity to similar types of material rights and under similar facts and circumstances.

The above issue is addressed in Implementation Q&A 15 (compiled from previously issued TRG Agenda Papers 18, 25, 32, and 34). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

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4 ASC 606-10-32-42 through 32-45 (paragraphs 87 through 90 of IFRS 15).
5 ASC 606-10-25-10 through 25-13 (paragraphs 18 through 21 of IFRS 15).
Example 11-4

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 (SSPs) 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.

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:

<table>
<thead>
<tr>
<th>Transaction Price ($)</th>
<th>SSP ($)</th>
<th>% Allocation</th>
<th>Allocation ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product X</td>
<td>200</td>
<td>50%</td>
<td>150</td>
</tr>
<tr>
<td>Service Y</td>
<td>100</td>
<td>25%</td>
<td>75</td>
</tr>
<tr>
<td>Material right</td>
<td>100</td>
<td>25%</td>
<td>75</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>300</strong></td>
<td><strong>100%</strong></td>
<td><strong>300</strong></td>
</tr>
</tbody>
</table>

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.

**Alternative A (Preferred)**

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.

**Alternative B (Acceptable)**

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:

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted transaction price ($300 + $300)</td>
</tr>
<tr>
<td>Revenue already recognized ($150 + $45)</td>
</tr>
<tr>
<td>Revenue not yet recognized</td>
</tr>
</tbody>
</table>
Example 11-4 (continued)

The revenue not yet recognized is then allocated to the remaining performance obligations as follows:

<table>
<thead>
<tr>
<th>Transaction Price ($)</th>
<th>SSP ($)</th>
<th>% Allocation</th>
<th>Allocation ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Y (40%)</td>
<td>40</td>
<td>8.2%</td>
<td>33</td>
</tr>
<tr>
<td>Service Z</td>
<td>450</td>
<td>91.8%</td>
<td>372</td>
</tr>
<tr>
<td>Total</td>
<td>405</td>
<td>100.0%</td>
<td>405</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Transaction Price ($)</th>
<th>SSP ($)</th>
<th>% Allocation</th>
<th>Allocation ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Y</td>
<td>100</td>
<td>18.2%</td>
<td>82</td>
</tr>
<tr>
<td>Service Z</td>
<td>450</td>
<td>81.8%</td>
<td>368</td>
</tr>
<tr>
<td>Total</td>
<td>450*</td>
<td>100.0%</td>
<td>450</td>
</tr>
</tbody>
</table>

* 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:

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue based on updated allocation for 60% of Service Y (60% × $82 = $49)</td>
</tr>
<tr>
<td>Revenue previously recognized for Service Y ($45)</td>
</tr>
<tr>
<td>Additional revenue recognized as catch-up adjustment</td>
</tr>
</tbody>
</table>

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.

11.8 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 sections 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:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Standalone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$100</td>
</tr>
<tr>
<td>Discount voucher</td>
<td>$12</td>
</tr>
<tr>
<td>Total</td>
<td>$112</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Allocated Transaction Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$89 ($100 ÷ $112 × $100)</td>
</tr>
<tr>
<td>Discount voucher</td>
<td>$11 ($12 ÷ $112 × $100)</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
</tr>
</tbody>
</table>

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.

11.8.1 Options to Purchase Goods at a Discount — Vouchers Available With or Without the Requirement to Make an Initial Purchase

The example below illustrates how the accounting for the use of a voucher that provides a customer with a discount could vary depending on whether the customer is required to make a purchase before receiving the voucher.
Example 11-5

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.

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 Section 6.4.2.3) on vouchers not expected to be redeemed.

11.8.2 Stand-Alone Selling Price for Gift Cards That Can Be Purchased Individually or in Combination With Other Goods or Services

The example below illustrates how the stand-alone selling price for gift cards could vary depending on whether the gift cards are purchased individually or are bundled with other goods or services.
Example 11-6

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).

In allocating the transaction price for purchases of headphones that include a gift card, T should 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. As discussed in Section 7.3.3.4, 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 under the assumption 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).

11.8.3 Retailer-Sponsored Coupons Provided Immediately After a Purchase Transaction

Retail stores sometimes provide retailer-sponsored coupons to customers immediately after a customer transaction (sometimes referred to as “Catalina” coupons). These coupons are printed at the register on the basis of an automated program and handed to the customer after a purchase is completed. An automated program connected to the register determines whether to provide targeted coupons to the customer as a result of various factors, such as items purchased by the customer or the amount spent. The coupons given to the customer can be used only in future purchases, often of specified products.

Sometimes, a customer may be capable of knowing in advance that he or she will be entitled to receive a particular coupon upon making a purchase. For example, a retailer may have advertised that it is running a price-matching campaign under which a customer will receive a coupon that represents the difference between the price paid for the goods purchased and the price that would have been paid for those same goods if bought from a competitor. This coupon can then be redeemed against future purchases the customer makes from the retailer.
Often, however, when a customer makes a purchase, he or she may have little or no expectation of either receiving a coupon from the retailer or being able to obtain particular goods by using such a coupon.

In accordance with ASC 606-10-55-42, the coupon would give rise to a performance obligation only if it provides a material right that the customer would not receive without entering into the transaction. This implies that the discount on the future good or service typically should be part of the negotiated exchange under the existing contract with the customer. To determine whether the offer is part of the negotiated exchange under the existing contract, the retailer would look to ASC 606-10-25-16, which states, in part:

>[T]he 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.

An entity will therefore need to use judgment under the particular facts and circumstances to ascertain whether it has made a promise (e.g., through advertising campaigns or its customary business practices) that has created a reasonable expectation on the part of a customer that he or she will receive a particular coupon upon making a purchase. An entity may also wish to consider the historical data on how many customers use the coupon for discounts on future purchases as part of its assessment of whether the coupon has a significant value to the customer and might therefore provide a material right.

In the price-matching campaign example described above, it is possible that the coupon to be redeemed against future purchases may give rise to a material right as part of the initial sale (see ASC 606-10-55-42 and 55-43 and Section 11.2 for guidance on making this determination) if the price-matching campaign has created a valid expectation on the part of the customer that he or she will receive a coupon for any excess amount paid as part of the current transaction.

However, if the customer has little or no expectation regarding any coupons that he or she might receive from the retailer, it is unlikely that a material right exists as part of the initial sale. In particular, the possibility that the customer will receive a coupon for a discount on future purchases when making a purchase is unlikely to have influenced the customer's buying decision to any meaningful extent. In such cases, the coupon is instead similar to a targeted coupon distribution based on customer purchasing habits. Such a coupon should be accounted for at the time of redemption in accordance with ASC 606-10-32-27, which states:

>[I]f 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.

### 11.9 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.” This practical alternative is included in ASC 606-10-55-45, which states:

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.

To differentiate contract renewal options from other types of options for additional goods or services (the latter of which are not eligible for the practical alternative if the optional goods or services are not similar to the original goods or services in the contract), 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.

These concepts are illustrated by Example 51 in ASC 606:

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### 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.
ASC 606-10 (continued)

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).

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:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$ 600</td>
</tr>
<tr>
<td>Year 2</td>
<td>$ 750</td>
</tr>
<tr>
<td>Year 3</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

55-348 Accordingly, the pattern of revenue recognition expected at contract inception for each contract is as follows:

<table>
<thead>
<tr>
<th>Expected Costs Adjusted for Likelihood of Contract Renewal</th>
<th>Allocation of Consideration Expected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1: $ 600 ($600 × 100%)</td>
<td>$ 780</td>
</tr>
<tr>
<td>Year 2: 675 ($750 × 90%)</td>
<td>877</td>
</tr>
<tr>
<td>Year 3: 810 ($1,000 × 81%)</td>
<td>1,053</td>
</tr>
<tr>
<td>Total: $ 2,085</td>
<td>$ 2,710</td>
</tr>
</tbody>
</table>

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.
Example 11-7 below further illustrates how to allocate consideration to renewal options that provide material rights to a customer.

### Example 11-7

ABC Company enters into 100 separate contracts with customers to provide a perpetual software license for $10,000 and one year of PCS for $1,000. The contracts include a customer option to renew PCS for an additional year for $500. ABC Company concluded that the renewal option represents a material right and the license and PCS are distinct performance obligations. ABC Company also determined that both the perpetual license and PCS were sold at stand-alone selling prices and estimated that the customer has a 75 percent probability of renewing at the end of year 1, 50 percent at the end of year 2, 25 percent at the end of year 3, and 0 percent at the end of year 4.

**Stand-Alone Selling Price Approach**

- Year 1 renewal = $375 ([$1,000 − $500] × 75%)
- Year 2 renewal = $250 ([$1,000 − $500] × 50%)
- Year 3 renewal = $125 ([$1,000 − $500] × 25%)

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Stand-Alone Selling Price</th>
<th>Relative Allocation</th>
<th>Allocation of Contract Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perpetual license</td>
<td>$10,000</td>
<td>85.1%</td>
<td>$9,362</td>
</tr>
<tr>
<td>PCS</td>
<td>1,000</td>
<td>8.5%</td>
<td>936</td>
</tr>
<tr>
<td>Renewal option — year 1</td>
<td>375</td>
<td>3.2%</td>
<td>351</td>
</tr>
<tr>
<td>Renewal option — year 2</td>
<td>250</td>
<td>2.1%</td>
<td>234</td>
</tr>
<tr>
<td>Renewal option — year 3</td>
<td>125</td>
<td>1.1%</td>
<td>117</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$11,750</td>
<td>100%</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

As a result of applying the stand-alone selling price approach, ABC Company would allocate $702 ($351 + $234 + $117) to the material right. In addition, ABC Company would recognize $10,298 in year 1.

**“Look Through” Approach**

If ABC Company chose to apply the practical alternative or “look through” approach, the company would estimate a hypothetical transaction price in one of two ways. The first approach is to determine the best estimate of the number of years that a customer would renew. Assume in this case that the company’s best estimate is that the customer will exercise the renewal option for two years.

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Stand-Alone Selling Price</th>
<th>Relative Allocation*</th>
<th>Allocation of Contract Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perpetual license</td>
<td>$10,000</td>
<td>76.9%</td>
<td>$9,231</td>
</tr>
<tr>
<td>PCS</td>
<td>1,000</td>
<td>7.7%</td>
<td>923</td>
</tr>
<tr>
<td>Renewal option — year 1</td>
<td>1,000</td>
<td>7.7%</td>
<td>923</td>
</tr>
<tr>
<td>Renewal option — year 2</td>
<td>1,000</td>
<td>7.7%</td>
<td>923</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$13,000</td>
<td>100%</td>
<td>$12,000**</td>
</tr>
</tbody>
</table>

* Rounded for presentation purposes.

** $10,000 + $1,000 + ($500 × 2).
Example 11-7 (continued)

This would result in recognition of $10,154 in revenue in year 1 ($9,231 + $923) and a deferral of $846 ($11,000 − $10,154) related to the material right.

However, in a manner consistent with Example 51 in ASC 606, an entity could also use a portfolio approach to estimate the hypothetical transaction price in the “look through” model. Under this approach, the entity would use the same probabilities applied in the stand-alone selling price model to determine the hypothetical transaction price. The following table illustrates this approach:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Stand-Alone Selling Price</th>
<th>Relative Allocation*</th>
<th>Allocation of Contract Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perpetual license</td>
<td>$ 10,000</td>
<td>71.6%</td>
<td>$ 8,394*</td>
</tr>
<tr>
<td>PCS</td>
<td>1,000</td>
<td>7.1%</td>
<td>839</td>
</tr>
<tr>
<td>Renewal option — year 1</td>
<td>1,000</td>
<td>7.1%</td>
<td>839</td>
</tr>
<tr>
<td>Renewal option — year 2</td>
<td>1,000</td>
<td>7.1%</td>
<td>839</td>
</tr>
<tr>
<td>Renewal option — year 3</td>
<td>1,000</td>
<td>7.1%</td>
<td>839</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 14,000</strong></td>
<td><strong>100%</strong></td>
<td><strong>$ 11,750</strong></td>
</tr>
</tbody>
</table>

* Rounded for presentation purposes.
** $10,000 + $1,000 + ($500 × 75%) + ($500 × 50%) + ($500 × 25%).

This would result in recognition of $9,233 in revenue in year 1 ($8,394 + $839) and a deferral of $1,767 ($11,000 − $9,233) related to the material right.

Note, however, that when a portfolio approach is applied, individual cancellations would not necessarily result in an immediate adjustment. This is because the overall estimates would incorporate a level of cancellations each period. It is only when the cancellation pattern of the overall portfolio changes that an entity would assess a potential change in estimate.

Connecting the Dots — 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.

In accordance with 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, in accordance with ASC 606-10-55-43, 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.

6 ASC 606-10-55-343 through 55-352.
11.10 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.

When a customer’s option to acquire additional goods is a material right and does not expire, recognition of revenue related to the option 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 11.2.2 for further discussion.
Example 11-8

**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.

**End of Year 1**

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.

**End of Year 2**

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:

$$4,370 = \left[\frac{50,000 \text{ total points redeemed}}{70,000 \text{ total points expected to be redeemed}}\right] \times 8,676 - 1,827 \text{ recognized in year 1}.$$

The contract liability balance is $2,479 ($6,849 − $4,370).

**End of Year 3**

After three years, 55,000 points in total have been redeemed, and the entity continues to expect that the customers will redeem 70,000 points in total. Therefore, the entity recognizes $620 in revenue in year 3. To calculate this amount, the entity determines what portion of the $8,676 is to be recognized in year 3 while maintaining the assumption that the total expected points to be redeemed is 70,000:

$$620 = \left[\frac{55,000 \text{ total points redeemed}}{70,000 \text{ total points expected to be redeemed}}\right] \times 8,676 - 1,827 \text{ (recognized in year 1)} - 4,370 \text{ (recognized in year 2)}.$$

The contract liability balance is $1,859 ($2,479 − $620).

**End of Year 4**

After four years, no additional points have been redeemed, and the entity concludes that the likelihood that customers will redeem the remaining points is remote. The total revenue recognized with respect to the material right in year 4 would be the remaining contract liability balance of $1,859.
Example 11-9

**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.

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 material right** — $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.

11.11 Amortization Period of Material Rights

In certain service contracts (e.g., month-to-month contracts), customers are required to pay a one-time “activation fee” upon initially signing up for the service. Often, the activities associated with the activation fee do not transfer a promised good or service to the customer. In these situations, the activation fee is attributed to the future services to be provided under the contract with the customer, as required under ASC 606-10-55-51, and generally would give rise to a material right if the customer can renew the service each month without incurring an additional activation fee (i.e., the renewal is offered at a significant discount). ASC 606-10-55-42 and ASC 606-10-55-51 provide the following limited guidance on how and over what period such a material right should be recognized:

55-42 . . . 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.

55-51 . . . 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.

Often in these circumstances, the option to renew services without incurring an additional activation fee is indefinite (i.e., the right to renew without paying an activation fee may exist for the entire customer relationship).

Activation fees that give rise to a material right should not necessarily be recognized over the entire customer life since the material right is not always related to all goods or services that will be provided to the customer under all anticipated contracts. Rather, an entity should determine the period over which the right to renew a contract without incurring an additional activation fee provides a material right to the customer. When making this assessment, an entity should consider both qualitative and quantitative factors. Examples of these factors include historical and projected customer behavior and the significance of the activation fee in relation to the monthly contract price. In addition to evaluating
qualitative factors, one way to make the assessment is to compare the renewal rate with the average monthly rate paid by the customer for the prior months’ services. Under this approach, the discount provided upon renewal diminishes with each successive renewal as the activation fee is attributed to additional months of service, as illustrated in Example 11-10 below.

**Example 11-10**

Entity A charges customers a monthly fee to obtain a bundle of services on a month-to-month basis (i.e., the contract period is one month, but customers have the right to renew the services at a consistent monthly rate). In addition, all new customers are required to pay a one-time activation fee to initiate the service, but this fee is not required upon renewal. No promised goods or services are transferred to customers in connection with activation activities. Entity A determines that the ability to renew a month of services without having to pay an additional activation fee creates a material right.

Assume the following additional facts:

- Each new customer pays a $30 activation fee that represents the stand-alone selling price of the material right.
- The customer can renew the monthly services for $140 per month indefinitely.
- Entity A has determined that its average customer life is seven years.

Although the customer can renew the monthly services indefinitely without incurring an additional activation fee, the period over which the right to do so represents a material right to the customer is likely to be less than seven years. While the option that exists in month 1 to renew services for month 2 provides the customer with a discount of approximately 17.6 percent as compared with the first month of services, the option to renew in month 8 provides only a 2.6 percent discount as compared with the average monthly amount paid to date. This is illustrated in the following table:

<table>
<thead>
<tr>
<th>Month</th>
<th>Aggregate fees paid ($140 × months of service + $30)</th>
<th>Average monthly fee paid to date (aggregate fees ÷ months of service = &lt;A&gt;)</th>
<th>Implied discount on renewal (&lt;A&gt; - $140 = &lt;B&gt;)</th>
<th>Discount on next renewal (&lt;B&gt; ÷ &lt;A&gt;)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 170.00</td>
<td>170.00</td>
<td>$ 30.00</td>
<td>17.6%</td>
</tr>
<tr>
<td>2</td>
<td>$ 310.00</td>
<td>155.00</td>
<td>$ 15.00</td>
<td>9.7%</td>
</tr>
<tr>
<td>3</td>
<td>$ 450.00</td>
<td>150.00</td>
<td>$ 10.00</td>
<td>6.7%</td>
</tr>
<tr>
<td>4</td>
<td>$ 590.00</td>
<td>147.50</td>
<td>$ 7.50</td>
<td>5.1%</td>
</tr>
<tr>
<td>5</td>
<td>$ 730.00</td>
<td>146.00</td>
<td>$ 6.00</td>
<td>4.1%</td>
</tr>
<tr>
<td>6</td>
<td>$ 870.00</td>
<td>145.00</td>
<td>$ 5.00</td>
<td>3.4%</td>
</tr>
<tr>
<td>7</td>
<td>$1,010.00</td>
<td>144.29</td>
<td>$ 4.29</td>
<td>3.0%</td>
</tr>
<tr>
<td>8</td>
<td>$1,150.00</td>
<td>143.75</td>
<td>$ 3.75</td>
<td>2.6%</td>
</tr>
<tr>
<td>9</td>
<td>$1,290.00</td>
<td>143.33</td>
<td>$ 3.33</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

In these circumstances, it is likely that the right to renew the contract without incurring an additional activation fee would not be material to the customer after a relatively short period. As a result, recognizing the activation fee over the entire customer life might not be required. Accordingly, A will need to use judgment to determine when the right to renew the contract without incurring an additional activation fee no longer provides a material right to the customer.
Chapter 12 — Licensing

12.1 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 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 obligations 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.

1 Refer to Section 4.4.1.1 for guidance on determining the contract term for certain licensing arrangements and Deloitte's July 24, 2018, Technology Alert for a discussion of challenges associated with applying the new revenue standard to licensing arrangements that involve termination rights.
Step 2: Identify the 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 approach could be used for determining the stand-alone selling price of one (or a bundle) of the performance obligations.\(^2\)

- **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), step 4 (allocate the transaction price), 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 assess the nature of the promised license to determine whether the license has significant stand-alone functionality. For licenses with significant stand-alone functionality, ongoing activities\(^3\) 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 generally not be required to 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.

\(^2\) Refer to Deloitte's February 28, 2019, Technology Alert for more information about estimating stand-alone selling prices for term licenses and postcontract customer support and Deloitte's June 12, 2019, Technology Alert for more information about the residual approach to estimating stand-alone selling prices and allocating the transaction price when a value relationship exists.

\(^3\) These do not include activities that transfer one or more goods or services to the customer (e.g., maintenance activities), which an entity must assess to determine whether they constitute separate performance obligations.
12.2 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:

- Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology
- Motion pictures, music, and other forms of media and entertainment
- Franchises
- Patents, trademarks, and copyrights.

Although the guidance above provides examples of licenses of IP, the term “intellectual property” is not formally defined in U.S. GAAP. However, paragraph BC51 of ASU 2016-10 states that “intellectual property is inherently different from other goods or services because of its uniquely divisible nature,” noting that “intellectual property can be licensed to multiple customers at the same time . . . and can continue to be used by the entity during the license period for its own benefit.” Identification of IP will require judgment.

**Connecting the Dots — Accounting for Licenses to Noncustomers**

The licensing guidance in the new revenue standard applies to licenses of IP that are an output of an entity’s ordinary activities (and, therefore, contracts to provide licenses of IP to customers). In some instances, an entity whose ordinary activities do not involve the licensing of IP may enter into a contract to provide a license of IP to a third party. Because the contract is not with a customer, the licensing guidance in the new revenue standard is not directly applicable. Further, because a derecognition event does not occur in a licensing transaction (i.e., there is no sale of the IP itself), the guidance in ASC 610-20 on accounting for gains and losses on the derecognition of nonfinancial assets is also not directly applicable. That is, a license of IP is outside the scope of ASC 610-20 since the license does not result in the transfer of the underlying IP when the entity still controls the IP (see Section 12.2.2 for more information about distinguishing between a license and an in-substance sale of IP).

We believe that an entity could apply the licensing guidance in the new revenue standard by analogy to account for the measurement and recognition of licenses of IP that are outside the scope of ASC 606 (i.e., licenses of IP that are not an output of the entity’s ordinary activities). For example, an entity could apply ASC 606 to determine whether a license of IP to a noncustomer represents a license to functional or symbolic IP. In addition, a license of IP to a noncustomer could include sales- or usage-based royalties, in which case an entity could apply the sales- or usage-based royalty exception in ASC 606. However, while an entity could apply aspects of ASC 606 by analogy, any gain or loss should not be presented or disclosed as revenue from contracts with customers.

If an entity entered into an agreement with a noncustomer to sell the underlying IP instead of licensing the IP (i.e., the entity transferred control of the IP and derecognized it), the sale would be within the scope of ASC 610-20. In that case, the sales- or usage-based royalty exception would not apply (because the exception applies only to licenses of IP). Rather, the entity would need to estimate and constrain royalties when determining the gain or loss it should record on the transfer of control of the IP.
12.2.1 Software in a Hosting Arrangement

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.

Connecting the Dots — Meaning of “at Any Time” in ASC 985-20-15-5(a)

Some may question whether “at any time” during the hosting period means at every point in time during the hosting period. We do not believe that to be the case. For example, an entity’s arrangements may specify that the customer will automatically obtain the software at the end of the hosting period. We believe that as long as the customer can take possession of the software at that point without significant penalty and it is feasible for the customer to run the software (either on its own or with a third-party vendor), the software license is a separate promise in the hosting arrangement and would therefore meet the criteria in ASC 985-20-15-5(a) and (b).

Many software hosting arrangements include a “license” to software but allow the customer to use the software only in the entity’s (rather than the customer’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 (service) rather than through an actual software license that is controlled by the customer.

Connecting the Dots — Third-Party Hosting Arrangements

It is common for software to be hosted on the platform or infrastructure of a third party rather than that of the vendor or customer. In these circumstances, it is important to determine who has the contract with the third party (i.e., whether it is the vendor’s or customer’s cloud instance of the third-party platform or infrastructure). If the software is hosted on the customer’s cloud instance, the customer has possession of the software, and the arrangement would be subject to the licensing guidance in the new revenue standard. By contrast, if the software is hosted on the vendor’s cloud instance and the customer cannot otherwise obtain possession of the software without significant penalty, the software is provided in a hosting arrangement and is excluded from the licensing guidance in the new revenue standard.

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4 When used in the context of cloud capacity, the term “cloud instance” refers to the cloud environment in which the software operates.
Example 12-1

Entity L, a software vendor, offers its office productivity package in an online format whereby a user accesses a Web site and stores files on a secure server. The applications will always be maintained at the most up-to-date version available, and customers have rights to online and telephone support. The customer will pay a fee of $200 for a one-year “right to use” license for software. Renewal fees are $200 for each subsequent year renewed. The customer does not have the ability to take possession of the software.

The license cannot be unbundled from the hosting service because the customer is not permitted to take possession and may only use the software together with L’s hosting service. Therefore, the criteria in ASC 985-20-15-5 are not met, and the arrangement consequently does not contain a license as described in ASC 606-10-55-54. Entity L should recognize the $200 over the one-year term of the arrangement once the customer has access to the hosted software.

As noted above, to determine whether a right to use software in a hosted environment includes a license within the scope of the new revenue standard’s licensing guidance, entities need to consider whether the software license is within the scope of ASC 985-20. For the software subject to a hosting arrangement to be within the scope of ASC 985-20 (and, therefore, within the scope of the licensing guidance in the new revenue standard), the criteria in ASC 985-20-15-5(a) and (b) must both be met.

ASC 985-20-15-6 states that the term “significant penalty” as used in ASC 985-20-15-5(a) contains the following two distinct concepts:

a. The ability to take delivery of the software without incurring significant cost
b. The ability to use the software separately without a significant diminution in utility or value.

The analysis for determining whether a significant penalty exists depends on the facts and circumstances of the arrangement and requires judgment. An entity may consider the following factors (not all-inclusive) in making this assessment:

- Contractual cancellation fees associated with the hosting arrangement.
- Other contractual penalties for taking possession of the software (e.g., the requirement that the customer continue to pay the hosting fees for the remainder of the hosting term even though hosting services are terminated).
- Costs of transitioning to (1) use of the software on the customer’s own servers or (2) hosting of the software by the customer’s third-party vendor.
- Whether the utility and value of the software can be maintained upon transition (e.g., whether (1) the customer will continue to receive updates, upgrades, and enhancements and (2) the software will be capable of providing the same functionality in another environment).
- Whether the software (1) has stand-alone functionality (on its own or with readily available resources) or (2) is significantly tied to other products or services that can be provided only by the entity and will no longer be provided if the customer takes possession of the software.
Significance can be evaluated both quantitatively and qualitatively. The accounting literature does not contain specific guidance on (1) which elements of the contract should be included in the measurement of the amount of the penalty or (2) the benchmark against which the entity should measure the amount of the penalty when determining whether the penalty is quantitatively significant. An entity may have an established policy for determining whether the penalty is significant. For example, in a manner consistent with other Codification subtopics, the entity may reasonably conclude that amounts above 10 percent of a given benchmark are significant. Establishing a method of determining both the elements of the contract to include in the measurement of the penalty and the benchmark against which to measure the penalty is an accounting policy decision that the entity should apply consistently.

Example 12-2

Company E is developing a customer relationship management (CRM) software solution to be marketed and sold to customers. The software will be provided to customers on a hosted basis (i.e., the software will be accessed by using an Internet connection) and will connect to E’s proprietary data analytics platform, which has already been developed and is housed on E’s own servers (i.e., it is a software as a service (SaaS) solution that is accessed only online). Company E’s data analytics platform will be a significant part of the overall solution sold to its customers and will be significantly integrated with the CRM software solution being developed. Company E plans to provide its customers with the contractual ability to take possession of the CRM software on an on-premise basis, when requested at any point during the hosting period, without paying E a penalty or cancellation fee. However, customers will not have the contractual ability to take possession of E’s data analytics platform. In addition, cancellation of the hosting service for the CRM software will also result in the cancellation of the SaaS for E’s data analytics platform, which cannot be easily replicated by the customer or third-party vendors. Further, customers would incur significant costs to integrate the CRM software with other third-party data analytics platforms.

While a customer will have “the contractual right to take possession of the software at any time during the hosting period” without paying E a penalty or cancellation fee, it cannot do so without incurring a significant penalty (i.e., significant diminution in utility or value of the CRM software without E’s data analytics platform). Therefore, E concludes that arrangements with customers for the CRM software solution do not meet the criteria to be accounted for as licensing arrangements.

12.2.2 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 (under either the guidance in ASC 606 unrelated to licenses if the sales arise from contracts with customers [see Chapter 4] or the guidance in ASC 610-20 on sales of nonfinancial assets if the sales are transactions with noncustomers [see Chapter 18]) 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 either a perpetual term or a period that is substantially the same as the IP’s useful life. Under legacy U.S. GAAP, revenue from an in-substance sale of IP is typically 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 12.7). 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. More specifically, the FASB noted in the Background Information and Basis for Conclusions of ASU 2016-10 that an entity should not distinguish between licenses and in-substance
sales in deciding whether the royalty exception applies. 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 discussion of the scope of the sales- or usage-based royalty exception, see Section 12.7.3.

12.2.3 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” 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.

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 since the original purchaser of the goods relinquishes all rights to the underlying IP if it sells or otherwise transfers 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.

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.

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5 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.

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12.3 Identifying Performance Obligations

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.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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<tr>
<td><strong>55-55</strong> 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.</td>
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| **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. |

When a license is included in an arrangement to provide additional goods or services, determining whether the license is distinct may require significant judgment. An entity would need to carefully evaluate whether the license is both capable of being distinct and distinct in the context of the contract. See Chapter 5 for additional considerations related to identifying performance obligations.

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.
Example 10 — Goods and Services Are Not Distinct

[Cases A and B omitted⁶]

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.

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.

⁶ Cases A and B of Example 10, on which Case C is based, are reproduced in Section 5.3.2.3.
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:

- The software license
- An installation service
- Software updates
- 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.
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.

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.

Example 55 — License of Intellectual Property

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.

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.

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).
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.

Example 56 — Identifying a Distinct License

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

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.

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.

Case B — License Is Distinct

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.

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.

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.
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.

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.

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.

Example 57 — Franchise Rights

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

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.
ASC 606-10 (continued)

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.

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.
   b. Subparagraph superseded by Accounting Standards Update No. 2016-10.
   c. Subparagraph superseded by Accounting Standards Update No. 2016-10.
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).

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.

Example 61A — Right to Use Intellectual Property

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 B — Contract Includes Two Promises

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.

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.

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.

The application of the new revenue standard to arrangements that include a license of IP may be challenging. In particular, the determination of whether rights promised to a customer in a licensing arrangement should be combined or separated is often complex and may require significant judgment. In the Background Information and Basis for Conclusions of ASU 2016-10, the FASB acknowledged such challenges as follows:

BC41 The Board previously observed that all contracts require an assessment of the promised goods and services in the contract and the criteria for identifying performance obligations (see paragraphs 606-10-25-14 through 25-22). This includes an assessment of whether a customer can benefit from the license on its own or together with other resources that are readily available to the customer (see paragraph 606-10-25-19(a)) and whether the entity's promise to transfer the license is separately identifiable from other goods or services in the contract (see paragraph 606-10-25-19(b)). The Boards observed that this assessment might sometimes be challenging.

BC42 Identifying separate deliverables (or elements) in licensing arrangements often is challenging under previous GAAP (for example, in many software or biotechnology arrangements), and it was never the Board's intention to eliminate judgment in this area. While stakeholders in industries that engage in significant licensing activities have questioned this, the Board concluded that no additional guidance on identifying performance obligations specifically tailored to entities that license intellectual property is necessary. The Board expects that the improvements in this Update will assist all entities in applying the general identifying performance obligations guidance in paragraphs 606-10-25-14 through 25-22, including entities that license intellectual property. [Emphasis added]
The Background Information and Basis for Conclusions of ASU 2014-09 and that of ASU 2016-10 both emphasize the need for an entity to use judgment when assessing whether promised goods or services are distinct within the context of the contract. Paragraphs BC27 and BC28 of ASU 2016-10 state the following:

**BC27** The criterion in paragraph 606-10-25-19(b) as well as the principle and the factors in paragraph 606-10-25-21 were developed with the understanding that application will require the exercise of judgment. This was in direct response to stakeholders’ feedback received during the development of Topic 606. Stakeholders expressed concerns that the proposed separation guidance in the 2010 and 2011 proposed Updates did not appropriately address the wide variety of revenue arrangements that existed in practice across all industries. Stakeholders asserted that the separation guidance might have resulted in the identification of performance obligations that do not appropriately reflect the arrangement with a customer.

**BC28** Stakeholders requested, and the Board decided to establish, guidance that permits judgment in this area. The Board observed that identifying separate deliverables or separate elements under existing revenue guidance also is challenging and judgmental, especially in particular industries. Although judgment is required, the Board has observed different interpretations of the criterion in paragraph 606-10-25-19(b) and the guidance in paragraph 606-10-25-21. For those reasons, the Board decided to clarify that guidance by better articulating the separately identifiable principle. Although the language describing the principle has been expanded, the amendments merely better describe the Board’s intentions and are not a change to the underlying principle. Even with the improvements in this Update, the Board recognizes that judgment will be needed to determine whether promised goods or services are distinct. [Emphasis added]

ASU 2016-10’s Background Information and Basis for Conclusions expands on the separately identifiable principle described in ASC 606-10-25-21 and the FASB’s intent regarding application of that principle as follows:

- **Focusing on the principle; inputs to a combined output** — Paragraph BC29 notes that the separately identifiable principle requires an entity to consider “whether the multiple promised goods or services in the contract are outputs or, instead, are inputs to a combined item (or items).” The paragraph goes on to explain that the “combined item . . . is greater than (or substantively different from) the sum of those promised (component) goods and services.” In addition, paragraph BC31 explains that the factors listed in ASC 606-10-25-21 are intended to support the principle and should not be viewed as criteria to be evaluated independently. If multiple promised goods or services represent inputs rather than individual outputs, such goods or services would not be separately identifiable.

- **Level of integration, interrelation, or interdependence** — Paragraph BC32 of ASU 2016-10 states, in part:

  The separately identifiable principle is intended to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. That is, the separately identifiable principle is intended to evaluate when an entity’s performance in transferring a bundle of goods or services in a contract is, in substance, fulfilling a single promise to a customer. Therefore, the entity should evaluate whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. The entity should not merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract).

The greater the level of integration, interrelation, or interdependence, the less likely it is that the promised goods or services are separately identifiable (i.e., the more likely it is that those goods or services should be combined into a single performance obligation). In a discussion not included in ASC 606 about how an entity should evaluate the level of integration, interrelation, or interdependence of multiple promised goods or services, paragraph BC116K of IFRS 15 states that “rather than considering whether one item, by its nature, depends on the other (i.e., whether two items have a functional relationship), an entity evaluates whether there is a transformative relationship between the two items in the process of fulfilling the contract.”
• **Diminution of utility** — As indicated below, paragraph BC33(b) of ASU 2016-10 discusses how the utility of a license may depend on updates to the license and therefore should be considered in the evaluation of whether multiple promised goods or services are separately identifiable:

> [In Example 10, Case C [ASC 606-10-55-140D through 55-140F], or in Example 55 [ASC 606-10: 55-364 through 55-366], the entity’s ability to transfer the initial license is not affected by its promise to transfer the updates or vice versa, but the provision (or not) of the updates will significantly affect the utility of the licensed intellectual property to the customer such that the license and the updates are not separately identifiable. **They are, in effect, inputs to the combined solution for which the customer contracted.** The “capable of being distinct” criterion also considers the utility of the promised good or service, but merely establishes the baseline level of economic substance a good or service must have to be “capable of being distinct.” Therefore, utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some economic benefit from each one, **the customer’s ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.** [Emphasis added]

When the utility of one promised good or service significantly depends on another promised good or service, it is less likely that those goods or services are separately identifiable. Specifically, an entity should consider (1) how quickly the utility of the initial license diminishes and, therefore, (2) how quickly the customer needs to incorporate any updates or upgrades to the licensed IP to continue to benefit and derive utility from the originally licensed IP.

### 12.3.1 Portfolio of Licenses to Patents

Some industries have a practice of selling a portfolio of licenses to patented IP (e.g., patented technology or know-how). Because the patented IP represents functional IP (see Section 12.4.1), the related licenses grant an entity’s customer a right to use the patented IP. In a typical arrangement to sell such a portfolio of licenses, the rights conveyed to the customer extend not only to all currently available patents (the “current patents”) but also to any patents that the entity develops later in the license term (the “future patents”). The effect of this type of arrangement is to expand the rights that are initially granted to the customer (i.e., the current patents) by providing the customer with the rights to future patents that are developed over the term of the arrangement. The current patents and future patents are capable of being distinct in accordance with ASC 606-10-25-19(a) because the customer is able to benefit from the current patents or future patents either on their own or together with readily available resources.

An entity that has entered into an arrangement with a customer to license a portfolio of patents should consider the “separately identifiable” principle in ASC 606-10-25-19(b) and related factors in ASC 606-10-25-21, including (1) whether the current patents and future patents are inputs to a combined output, (2) the level of integration, interrelation, or interdependence between the current patents and future patents, and (3) the diminution of the utility of the current patents without a right to the future patents. For example, the entity should consider (1) how quickly the utility of the current patents diminishes once new patents are issued and (2) how quickly the customer needs to incorporate any updates and upgrades to the current patents to continue benefiting and deriving utility from the current patents. If the entity is required to immediately update the portfolio for any new patents once issued, that may suggest that the utility of the current patents is significantly diminished without the new patents.

The entity should consider its facts and circumstances when it assesses the separately identifiable principle to determine whether the initially delivered rights (i.e., the current patents) are distinct within the context of the contract from the ongoing rights that it is contractually required to deliver over the term of the agreement (i.e., the future patents).
12.3.2 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, geographical region, or 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.

a. Subparagraph superseded by Accounting Standards Update No. 2016-10
b. Subparagraph superseded by Accounting Standards Update No. 2016-10.

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.

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 Example 12-3 below.
Example 12-3

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 exchange for a fixed fee of $100,000. The entity concludes that the license is a right to access IP that will be transferred to the customer over time. 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. Further, 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.

In allocating the transaction price of $100,000 to the two performance obligations, the entity determines that the stand-alone selling prices of delivering the license to Jurisdiction A for two years and Jurisdiction B for one year are $60,000 and $40,000, respectively. Under these circumstances, the entity would then recognize revenue of $30,000 over year 1 and $70,000 over year 2, which is calculated as follows:

- **Year 1 (Jurisdiction A)** — ($60,000 ÷ 2) × 1 year of service = $30,000.
- **Year 2 (Jurisdiction A)** — ($60,000 ÷ 2) × 1 year of service = $30,000.
- **Year 2 (Jurisdiction B)** — $40,000 × 1 year of service = $40,000.

The example above assumes that the license constitutes a right to access IP that will be transferred to the customer over time. The determination of whether a license is a right to access IP for which revenue is recognized over time or a right to use IP for which revenue is recognized at a point in time is discussed in Section 12.4.

Paragraph BC45 of ASU 2016-10 indicates that a substantive break between the periods for which an entity’s customer has the right to use IP might create multiple licenses since the substantive break “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 [IP] again at the later date.” Accordingly, an entity should use judgment to determine whether a break is “substantive” and therefore creates an additional license of IP (i.e., a separate performance obligation).

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.

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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.

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.
ASC 606-10 (continued)

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.

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.

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.
Chapter 12 — Licensing

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. 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.

12.3.3 Distinguishing an Option to Acquire Additional Rights From Provisions Giving Rise to Variable Consideration in the Form of a Sales- or Usage-Based Royalty

As discussed in ASC 606-10-55-64, contractual provisions in a licensing transaction may allow an entity's customer to obtain additional benefits or rights after the initial transfer of the license. An entity may need to use significant judgment to differentiate between contractual terms that allow a customer to obtain additional rights that the customer does not already control (thereby creating additional performance obligations) and contractual terms that allow for additional usage of IP already controlled by the customer (which would not create additional performance obligations but may entitle the entity to additional variable consideration in the form of a sales- or usage-based royalty). The entity will need to evaluate any option to acquire additional rights to use or access the IP to determine whether the option gives rise to a material right.

Paragraph BC46 of ASU 2016-10 states that “judgment often is required in distinguishing a single promised license with multiple attributes from a license that contains multiple promises to the customer in the contract.” The determination of whether contractual provisions that allow the customer to obtain additional benefits or rights constitute optional purchases or variable consideration related to rights already controlled by the customer could affect the timing of revenue recognition if the optional additional rights give rise to a material right.

When options to acquire additional rights not already controlled by the customer are priced at their stand-alone selling prices, the timing and amount of revenue recognized will most likely be the same as if the contractual rights gave rise to variable consideration in the form of a sales- or usage-based royalty. However, the differentiation may still be important since consideration in the form of a sales- or usage-based royalty is a form of variable consideration to which the disclosure requirements in ASC 606-10-50-15 might apply (e.g., if the nature of the license is a right-to-access license of IP that is transferred to the customer over time).
An entity will need to use judgment on the basis of the specific facts and circumstances of the arrangement to determine whether (1) the contract includes an option to acquire additional rights to use or access IP or (2) the contractual provisions give rise to variable consideration in the form of a sales- or usage-based royalty.

The following factors may indicate that the contractual provisions (1) give the customer an option to acquire additional rights to use or access IP or (2) represent an obligation to transfer additional rights to the customer that constitutes a separate performance obligation:

- The customer's right to use or access the initial IP changes when the additional rights are obtained (e.g., the customer can embed the IP within a new or different product or can use the IP in a different geographical area).

- The customer obtains new or expanded functionality as a result of the additional rights obtained.

- The additional rights obtained for a fee continue for the duration of the license agreement rather than expiring upon usage, and the additional usage during that period does not result in additional fees. That is, the additional rights are acquired for an additional initial fee, but the additional rights are not wholly consumed once the rights are acquired (e.g., the customer expands the use of functional IP from 100 users to 200 users for the duration of the license term) and no ongoing usage fee is payable.

- The license is transferred to a reseller (requiring the reseller to pay a fee per copy, license, or end user upon making a purchase or sale), and the reseller is not using the functionality provided by the license itself but is transferring the rights to use the IP to end users. Because the reseller is simply purchasing and reselling the software product, the software product is more akin to any other tangible product that is purchased for resale. In these situations, the transaction between the vendor and the reseller is one in which the vendor is selling and the reseller is purchasing incremental software rights that the reseller does not already control each time the reseller pays a fee to transfer the vendor's software to an end user.

The following factors may indicate that the contractual provisions give the customer a right to additional usage of a single license, which would give rise to variable consideration:

- The customer controls the rights to use or access the IP but is required to pay additional consideration based on how often the IP is used (e.g., consideration is payable each time the IP performs a task, or each time the IP is integrated into a device and contributes to the device's functionality).

- The additional usage of the IP does not provide sustained additional benefits without additional fees. For example, a customer may have to pay a fee each time it uses software to perform a task rather than a fixed fee that allows the customer to continually use the software to perform tasks.

Sometimes, specific performance by the licensor will be required before additional rights are granted or additional usage of a single license is allowed. For example, a software licensor may need to provide the licensee with a software key each time software is embedded in a device. The fact that the licensor is required to provide a software key for each license does not necessarily mean that a new right is transferred to the licensee with each key (i.e., specific actions required by the licensor are not in and of themselves determinative of whether additional rights have been transferred to the licensee). Rather, an entity should evaluate all facts and circumstances when determining whether contractual provisions (1) give a customer the right to acquire additional rights to use or access IP that it does not already control in exchange for additional consideration or (2) give rise to variable consideration in the form of a sales- or usage-based royalty.
12.3.3.1  Accounting for a Customer's Option to Purchase or Use Additional Copies of Software

A software 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.

As discussed in Section 12.3.3, an entity in a right-to-use license arrangement will need to use judgment to determine whether the nature of the arrangement is to provide the customer with an option to obtain additional rights (e.g., for additional users) or to require payment of incremental fees for additional usage of rights already controlled by the customer.

An arrangement in which an entity provides an option to the customer to obtain rights for additional users typically represents 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. For further discussion, see Section 12.3.3.2.

In some cases, additional copies of a software license could represent additional usage of a single license as opposed to additional users. As discussed in Section 12.3.3, an entity will need to use judgment on the basis of the specific facts and circumstances of the arrangement. For example, the ability to use additional copies of a license for an incremental fee in certain reseller arrangements could represent additional usage as opposed to optional purchases of additional rights (see Example 12-5).

An arrangement in which an entity provides additional usage of a single license (i.e., usage of rights already controlled by the customer) could include 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 (under the assumption that the license is predominant if there are multiple promises) and be recognized no earlier than when the subsequent usage occurs.

Example 12-4

Licensor sells Customer Y 1,000 licenses of Product A for $50,000. Each license allows Y one seat to use Product A for the duration of the contract term. Customer Y can purchase additional licenses of Product A for $30 per license that will allow Y to use Product A in an additional seat (i.e., add users). Licensor provides separate activation keys for each license. Customer Y can use additional licenses purchased for the remaining contract term.

The option to acquire additional licenses would be viewed as an option that gives the customer additional rights (and, therefore, as an additional performance obligation if the option gives rise to a material right). This is because if Y exercises the option to acquire additional licenses to Product A, Licensor would be required to transfer additional rights for additional users that Y does not already control. Therefore, Licensor should evaluate the option to determine whether it gives rise to a material right.

7 While this section addresses additional rights associated with users, additional rights could also include other incremental licenses, such as the right to use the software at additional locations or for different business segments.
Example 12-5

Licensor provides OEM with a master copy of software that OEM can use to reproduce copies of the license for integration only into Product A, which contributes to Product A’s functionality. OEM pays Licensor a fee of $50 for each use (i.e., integration into Product A) up to 1,000 uses and $30 for each use above 1,000 licenses.

The customer controls the rights provided by the software license and has committed to pay a fee that varies depending on the use of the license (rather than on the basis of additional rights acquired, which would be a separate performance obligation). The rights provided by the software give rise to variable consideration to which the sales- or usage-based royalty exception in ASC 606-10-55-65 through 55-65B applies.

Example 12-6

Assume the same facts as in Example 12-5 above, except that the contract gives OEM the option to obtain the right to integrate the software into Product B (and contribute to Product B’s functionality) for an additional $10,000. If the right is exercised, OEM will also pay a fee of $40 for each use of the software in Product B (the price of the software included in Product A remains unchanged). OEM will use the same master copy to replicate the software as that provided in Example 12-5, which requires no action by Licensor.

The option to acquire the rights to include the software in Product B allows OEM to acquire additional rights to use the IP (and is therefore an additional performance obligation if the option gives rise to a material right). That is, the OEM does not have the right to integrate the software into Product B unless it exercises the option, at which point Licensor will transfer additional rights to OEM that OEM does not already control. Therefore, Licensor should evaluate the option to determine whether it gives rise to a material right. The additional consideration that is paid to Licensor for each use of the software in Product B is variable consideration to which the sales- or usage-based royalty exception in ASC 606-10-55-65 through 55-65B applies.

Example 12-7

Licensor enters into a five-year contract to sell an unknown quantity of software licenses to Reseller. Each license gives Reseller the right to resell the individual software licenses to end users. Reseller does not have any other rights related to the software. Reseller pays $50,000 for the first 2,500 software licenses that can be downloaded on demand. Further, Reseller pays $15 for each additional software license sold above the initial 2,500 licenses during the five-year contract term.

In this example, Reseller obtains the right to resell Licensor’s software but does not obtain end-user rights associated with the software. Any additional consideration above the initial $50,000 payment is in exchange for Licensor’s granting additional software licenses that Reseller will resell to end users. That is, Licensor transfers additional rights to Reseller with each additional license.

In addition, because the price per license sold after the initial 2,500 licenses ($15 per license) is less than the price per license for the first 2,500 licenses ($20 per license), Licensor should consider whether there is a material right related to the right to purchase additional software licenses.

The above issue is addressed in Q&A 58 (compiled from previously issued TRG Agenda Papers 45 and 49) of the FASB staff’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.
12.3.3.2 Material Right Assessment

If an entity in a right-to-use license arrangement determines that the arrangement provides for an option to purchase additional rights such as users (i.e., an option to acquire additional licenses, which would constitute additional performance obligations), the entity should perform an evaluation in accordance with ASC 606-10-55-42 to determine whether the customer’s option to add licenses at a later date on the basis of a per-license fee represents a material right. If the option represents a material right, the entity should allocate a portion of the transaction price for the initial license rights to the material right.

If the option does not represent a material right, the entity would not account for the additional license rights until the subsequent purchases for additional licenses 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 (under the assumption that the license is predominant if there are multiple promises). As a result, for a right-to-use license, revenue would be recognized no earlier than when the subsequent usage occurs.

The above issue is addressed in Implementation Q&A 58 (compiled from previously issued TRG Agenda Papers 45 and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

12.3.3.3 Customer’s Ability to Access or Download Additional Copies of Software

Whether an entity (i.e., a software vendor) is involved in reproducing software copies does not in itself determine whether an arrangement includes rights to additional users or usage of software. Example 12-8 below illustrates how an entity (the vendor) in a software arrangement with a customer should account for the customer’s ability to access or download additional copies of software when adding users may or may not require additional direct involvement by the vendor.

Example 12-8

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.

The vendor must use judgment to determine whether the additional copies in 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.
Example 12-8 (continued)

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 Example 12-15, 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 copies of a license requires additional direct involvement by the vendor. In all three scenarios above, the vendor should evaluate the arrangement 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 accounting for the initial 500 copies (i.e., the committed volume by the customer) is not the subject of this example. Rather, this example addresses only the additional copies in excess of the initial 500 copies to be delivered to the customer.

The above issue is addressed in Implementation Q&A 58 (compiled from previously issued TRG Agenda Papers 45 and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

12.3.4 License Keys and Termination Provisions

ASC 606-10-25-3 provides that an entity should apply the guidance in ASC 606 “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 some contracts, termination provisions can affect the contractual term and, therefore, the enforceable rights and obligations between the parties.

Example 12-9 below illustrates how termination provisions in a software licensing contract requiring the delivery of a license key for the customer to use the software affect the identification of performance obligations and the recognition of revenue.

Example 12-9

Company LEH enters into an arrangement to license its software (a right-to-use license for which revenue is recognized at a point in time) to Customer MJR for one year with coterminous postcontract customer support (PCS). The annual fee for the license and PCS is $5,000 (paid quarterly). Company LEH determines that the stand-alone selling price of the license is $4,000 and the stand-alone selling price of the PCS is $1,000. Company LEH delivers a license key to MJR at the beginning of each quarter; the license key is required for MJR to use the software. Company LEH determines that the license and PCS are distinct performance obligations.
Example 12-9 (continued)

Consider the following cases:

- **Case A: contract may be terminated at the end of each quarter during the one-year license term** — In Case A, MJR may choose not to make the next quarterly payment, thereby alleviating LEH's obligation to deliver the quarterly license key and provide further PCS. Customer MJR's election not to pay the quarterly fee is not deemed to be a breach of the contract, and LEH has no recourse against MJR if payment is not received (other than to discontinue providing the license and PCS). In effect, the contract is cancelable each quarter. Upon cancellation, MJR's rights to use the license and receive PCS for the remainder of the one-year license term are also revoked.

- **Case B: contract may not be terminated during the one-year license term** — In Case B, LEH is required to deliver or make available the license key to MJR at the beginning of each quarter (such obligation is not contingent on MJR's making quarterly payments). If LEH does not deliver or make available the license key at the beginning of each quarter, LEH will be in breach of its contractual obligations. Similarly, MJR will be in breach of its contractual obligations if it does not make the quarterly payments. Company LEH has agreed to deliver license keys on a quarterly basis as protection against a breach of contract by MJR. For example, if MJR fails to make payment on time at the start of the second quarter, LEH would still deliver the license key for that quarter. But if MJR has still not paid by the end of the second quarter and is therefore clearly in breach of its contractual commitments, LEH could consider whether to withhold the license key for the third quarter in response to MJR's breach of contract. The contract may not be terminated by either LEH or MJR during the one-year license term, and LEH has a history of enforcing the contract term.

In Case A, because the contract may be canceled at the end of each quarter, LEH does not have an unconditional obligation to deliver the license key to MJR after the first quarter, nor does MJR have the unconditional obligation to continue making quarterly payments to LEH. Because the contract is cancelable by MJR each quarter, the contract term is limited to one quarter unless MJR renews the contract (by making the quarterly payment). At contract inception (i.e., when the first license key is transferred to MJR), MJR obtains a right to use a license for only a term of one quarter. If MJR elects not to cancel the contract and LEH transfers an additional key to MJR, MJR obtains the rights to use and benefit from the software and receive PCS for an additional quarter.

In this case, LEH transfers control of a license for one quarter and is required to provide one quarter of PCS each time MJR elects not to terminate the contract. Therefore, LEH should recognize revenue of $1,000 allocated to the license at the beginning of each quarter and $250 allocated to PCS over the quarterly PCS period.

In Case B, LEH should account for the arrangement as a promise to transfer a one-year term license and one year of PCS. Although a new license key is required to be delivered or made available at the beginning of each quarter, LEH and MJR have entered into a noncancelable contract that gives MJR the right to use the software for one year. As noted in Example 12-15, control of a license can be transferred even if the product key is not transferred to the customer as long as the key is made available to the customer (and accessing the key is within the customer's control). In Case B, MJR has an enforceable right to demand the license key, and LEH is obligated to transfer or otherwise make available to MJR the key each quarter (regardless of whether MJR makes timely payments). Accordingly, once LEH initially transfers the license (and key) to MJR, MJR obtains control of the one-year term license. Because LEH does not have the ability to terminate the contract in the absence of a breach of contract by MJR or to prevent MJR from accessing the license key each quarter, LEH transfers all of the rights to use and benefit from the software for the entire one-year license term at contract inception. Similarly, MJR does not have the right to terminate the contract and cease making quarterly payments since the contract is noncancelable and LEH has a history of enforcing the contract term.

Accordingly, LEH should recognize revenue of $4,000 allocated to the license at contract inception (when the initial key is delivered) and $1,000 allocated to PCS over the PCS term (i.e., one year).
12.3.5 Accounting for Bundled Licensing Arrangements — Right to Use New Content

In certain cases, a TV network may license its library of historical content as well as provide a right to use all future content it develops to a broadcaster that is seeking to be the distributor of the TV network's content in the broadcaster's territory. As part of the transaction, the TV network might also provide the broadcaster the right to sell a digital streaming subscription service that includes access to the historical content as well as all future content.

Example 12-10 below illustrates how an entity should determine whether a license to use a library of historical content and all future content represents more than one performance obligation.

Example 12-10

Network XYZ, a U.S.-based cable TV network, enters into a three-year arrangement with a foreign distributor. In accordance with the arrangement:

- The foreign distributor is granted an exclusive license that includes digital streaming rights (in the foreign distributor's territory) to XYZ's library of historical content as well as XYZ's new content that becomes available during the three-year term. Network XYZ has determined that its license to historical and new content is a license to functional IP.
- The foreign distributor plans to launch its XYZ Network subscription service in its territory at the inception of the arrangement.
- The library of historical content is transferred to the foreign distributor at inception.
- Network XYZ's new content is made available after it is aired on Network XYZ and is immediately added to the library available to the foreign distributor for digital streaming.

The foreign distributor believes that potential subscribers to its service attach a significant degree of importance to XYZ's new content. Therefore, the foreign distributor believes that if it did not have access to the new content, it would face a challenge in attracting subscribers — even at a lower price — to a subscription service containing only the content available at contract inception.

The right to use the library of historical content and all future content would generally represent two performance obligations. In accordance with ASC 606-10-25-19 through 25-22, XYZ is required to assess whether the promise to grant a license to the existing content is distinct from the right to use new content when and if new content is made available by XYZ. For licenses of functional IP, it is important to determine whether updates (e.g., rights to use new content) significantly affect the functionality of the license transferred at inception. In the determination of whether the license is capable of being distinct, we would expect that the foreign distributor can benefit from the functionality provided by the existing content on its own without the updates. Although the updates may be important for the foreign distributor to attract subscribers, the updates do not significantly modify the functionality of the historical content, and the historical content does not significantly modify the functionality of the new content. In addition, the historical content and the new content are not significantly integrated, highly interdependent, or highly interrelated, and XYZ can satisfy its promise to transfer the rights to use the historical library of content independently from satisfying its promise to transfer the right to use new content.

However, entities should carefully analyze their facts and circumstances.
12.3.6 Identifying Performance Obligations in a Hybrid Software Arrangement

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

Example 12-11

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

We believe that it is reasonable to conclude that the entity has promised (1) to provide the right to use 1,000 software licenses of Product X and (2) to stand ready to provide a cloud-based service (i.e., to host the software licenses). If each of the promises is distinct, there are two performance obligations to which the nonrefundable $100,000 fee should be allocated on a relative stand-alone selling price basis (refer to Chapter 7 for a discussion about allocating the transaction price). Consideration allocated to Product X (i.e., the on-premise software licenses) would be recognized once control of Product X is transferred to the customer (refer to the discussion in Section 12.5). Since the performance obligation to provide the hosting service is satisfied over time, consideration allocated to this performance obligation should be recognized as revenue over the three-year contract term (i.e., the period over which the entity is required to stand ready to provide the hosting service).

The functionality of on-premise software and a cloud-based service in a hybrid cloud-based arrangement can vary between offerings to customers and between entities. When identifying performance obligations in a hybrid cloud-based arrangement, an entity should consider the guidance in ASC 606-10-25-19 through 25-21 to determine whether the on-premise software and the cloud-based service are distinct (see Chapter 5 for further discussion of the guidance on determining whether promises in a contract are distinct). In making this determination, an entity may consider the following indicators, which are not individually determinative or all-inclusive:

- **Whether the entity's on-premise software and cloud-based service are ever sold separately** — The entity's practice of selling the on-premise software or the cloud-based service separately typically indicates that there are two separate performance obligations (i.e., the promises should not be combined) since the customer may benefit from the on-premise software or the cloud-based service on its own. Separate sales also suggest that the on-premise software and the cloud-based service each have significant stand-alone functionality, which indicates that they are distinct within the context of the contract. For example, if the on-premise software separately

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8 In accordance with ASC 606-10-55-54 and ASC 985-20-15-5, software subject to a hosting arrangement is a license of IP (i.e., on-premise software) if (1) the “customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty” and (2) “[i]t 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.”
provides substantially the same functionality as the cloud-based service, the two promises are likely to be distinct.

- **Whether the customer can benefit from each product or service (i.e., the on-premise software or the cloud-based service) either on its own or together with other resources that are readily available to the customer** — For example, suppose that the customer has the ability to (1) obtain the same or similar cloud-based service from a different vendor, (2) use the alternative vendor's cloud-based service with the entity's on-premise software, and (3) receive substantially the same combined functionality as that of the entity's hybrid offering. That ability may indicate that the entity's on-premise software and cloud-based service each are capable of being distinct and are distinct within the context of the contract since (1) the entity is not providing a significant integration service for the on-premise software and the cloud-based service and (2) it is less likely that the on-premise software and the cloud-based service are highly interdependent or highly interrelated.

Alternatively, suppose that the functionality of the on-premise software is significantly integrated with (rather than just improved by) the cloud-based service in such a way that the entity's hybrid offering provides significant additional capabilities that cannot be obtained from an alternative vendor providing the cloud-based service. In that case, the presence of an alternative vendor providing a portion of the same utility with its cloud-based service would indicate that the promises are capable of being distinct, but the integrated nature of the promises would indicate that the promises are not distinct within the context of the contract.

- **Whether the cloud-based service significantly modifies the on-premise software** — The cloud-based service and the on-premise software may not be distinct within the context of the contract if rather than just enhancing the capabilities of the on-premise software, the cloud-based service modifies and significantly affects the functionality of the on-premise software. For example, suppose that the cloud-based service (1) employs artificial intelligence (AI) or machine learning that teaches and significantly affects the functionality of the on-premise software and (2) cannot employ the AI or machine learning without using the functionality of the on-premise software. This situation would indicate that the cloud-based service and the on-premise software are not distinct within the context of the contract because rather than just enhancing the capabilities of the on-premise software, the cloud-based service modifies and significantly affects the functionality of the on-premise software.

- **Whether the absence of either the on-premise software or the cloud-based service significantly limits or diminishes the utility (i.e., the ability to provide benefit or value) of the other** — If the on-premise software's functionality is significantly limited or diminished without the use of the cloud-based service, and vice versa, that significantly limited or diminished functionality may indicate that the on-premise software and the cloud-based service (1) are highly interdependent or highly interrelated (i.e., they significantly affect each other) and (2) function together as inputs to a combined output. This, in turn, may indicate that the promises are not distinct within the context of the contract since the customer cannot obtain the intended benefit of the on-premise software or the cloud-based service without the other. That is, while the customer may be able to obtain some functionality from the on-premise software on a stand-alone basis, it would not obtain the intended outputs from the on-premise software if the on-premise software is not connected to the cloud-based service because the cloud-based service is critical to the customer's intended use of the hybrid solution. In this situation, the entity cannot fulfill its promise to the customer by transferring the on-premise software or the cloud-based service independently (i.e., the customer could not choose to purchase one good or service without significantly affecting the other good or service in the contract).
• **Whether the functionality of the combined on-premise software and cloud-based service is transformative rather than additive** — Transformative functionality should be assessed separately from additive functionality. Transformative functionality comprises features that significantly affect the overall operation and interaction of the on-premise software and the cloud-based service (e.g., collaboration, pushdown learning, customization). To be transformative, the on-premise software and the cloud-based service must significantly affect each other. That is, the on-premise software and the cloud-based service are inputs to a combined output such that the combined output has greater value than, or is substantively different from, the sum of the inputs. By contrast, additive functionality comprises features that provide an added benefit to the customer without substantively altering (1) the manner in which the functionality is used and (2) the benefits derived from the functionality of the on-premise software or the cloud-based service on a stand-alone basis. Even if added functionality is significant, it may not be transformative. It is more likely that the on-premise software and the cloud-based service are highly interdependent or highly interrelated when the functionality of the combined on-premise software and cloud-based service is transformative rather than additive.

• **Whether the entity’s marketing materials support a conclusion that the arrangement is for a combined solution rather than separate products or service offerings** — The entity’s marketing materials may help clarify what the entity has promised to deliver to its customer and may provide evidence of the customer’s intended use of the on-premise software and the cloud-based service. Circumstances in which an entity markets its product as a “solution” (i.e., the marketing materials discuss the functions, features, and benefits of the combined offering with little or no discussion of the on-premise software and the cloud-based service separately) may help support a conclusion that the entity’s promise is a combined performance obligation. However, the entity should exercise caution when relying on its marketing materials since the manner in which the entity markets its hybrid offering would not, by itself, be sufficient to support a conclusion that the on-premise software and the cloud-based service represent a combined performance obligation.

Identifying performance obligations in hybrid cloud-based arrangements requires judgment, and the determination of whether offerings in such arrangements constitute a single performance obligation or multiple performance obligations will depend on the facts and circumstances. A conclusion that the offerings in a hybrid cloud-based arrangement represent a single performance obligation should be carefully considered under ASC 606-10-25-19 through 25-21.

**Example 12-12**

Entity A is a developer of modeling software that enables its customers to analyze, design, and render virtual prototypes to assess the real-world impact of products its customers are developing. Entity A enters into a three-year noncancelable contract with a customer to provide (1) an on-premise license to the software and (2) a cloud-based service, which is an online repository for in-process and final prototypes that can be accessed by the customer’s employees from any device that also has the on-premise software. While the on-premise software and the cloud-based service are never sold separately and are marketed as an integrated offering, the on-premise software is fully functional without the cloud-based service and has significant utility on its own. The cloud-based service provides the added benefit of allowing the customer’s employees to share and collaborate on projects but is similar to other cloud-based services provided by alternative vendors. Those other cloud-based services would require only minimal modifications to function with A’s on-premise software.
Example 12-12 (continued)

We believe that it is reasonable to conclude that the on-premise software license and the cloud-based service are two separate performance obligations for the following reasons:

- While the on-premise software and the cloud-based service are not sold separately and are marketed as an integrated offering, there are other vendors that provide similar cloud-based services.
- The cloud-based service does not significantly modify the on-premise software but merely serves as a repository for sharing prototypes.
- The on-premise software is not significantly integrated with the cloud-based service since alternative cloud-based services would require only minimal modifications to function with the on-premise service.
- The absence of the cloud-based service does not significantly limit or diminish the utility of the on-premise software (the intended use of the on-premise software is to analyze, design, and render virtual prototypes).
- The functionality provided by the cloud-based service (added storage and collaboration functionality) is additive rather than transformative.

Example 12-13

Entity B is a developer of modeling software that enables its customers to analyze, design, and render virtual prototypes to assess the real-world impact of products its customers are developing. Entity B enters into a three-year noncancelable contract with a customer to provide (1) an on-premise license to the software and (2) a cloud-based service. The cloud-based service serves as an online repository for in-process and final prototypes that can be accessed by the customer's employees from any device that also has the on-premise software. In addition, the cloud-based service interacts with the on-premise software to provide continuous real-time data updates, data mining and analysis, predictive modeling, and machine-based learning (which are computationally intensive tasks that can be performed only through the cloud-based service) to enable the customer to enhance and improve its products. The nature of the customer's products makes their continual enhancement and improvement critical because without such continual enhancement and improvement, the products would quickly become obsolete. Similarly, functions performed by B's cloud-based service are critical because without those functions, the on-premise software would have little utility to the customer.

The on-premise software and the cloud-based service are never sold separately and are marketed as an integrated offering. There is significant integration of, and interaction between, the on-premise software and the cloud-based service such that together, they provide the functionality required by the customer. The cloud-based service is proprietary and can be used only with the on-premise software; no other competitors can provide (1) a similar service that can function with B's on-premise software or (2) a software product that can function with B's cloud-based service. Accordingly, B determines that there is a transformative relationship between the on-premise software and the cloud-based service such that they are inputs to a combined output. Further, because the on-premise software and the cloud-based service each have little or no utility without the other, they are highly interrelated and highly interdependent.
Example 12-13 (continued)

We believe that it is reasonable to conclude that there is one performance obligation (an integrated hybrid cloud-based offering) for the following reasons:

- Entity B’s on-premise software and cloud-based service are never sold separately.
- The customer cannot benefit from the on-premise software or the cloud-based service either on its own or together with other resources that are readily available to the customer. There is no on-premise software or cloud-based service available from other vendors that can function with B’s offering.
- The functionality of the on-premise software is significantly integrated with that of the cloud-based service in such a way that only together can the on-premise software and the cloud-based service provide the functionality (i.e., the intended benefit) required by the customer.
- The absence of either the on-premise software or the cloud-based service significantly limits or diminishes the utility (i.e., the ability to provide benefit or value) of the other. The on-premise software’s functionality is significantly limited or diminished without the use of the cloud-based service, and vice versa. Therefore, the on-premise software and the cloud-based service (1) are highly interdependent and highly interrelated (i.e., they significantly affect each other) and (2) function together as inputs to a combined output. The customer cannot obtain the full intended benefit of the on-premise software or the cloud-based service on a stand-alone basis because each is critical to the customer’s intended use of the hybrid solution. Therefore, B cannot fulfill its promise to the customer by transferring the on-premise software or the cloud-based service independently (i.e., the customer could not choose to purchase one good or service without significantly affecting the other good or service in the contract).
- The functionality of the combined on-premise software and cloud-based service is transformative rather than additive. That transformative functionality comprises features that significantly affect the overall operation and interaction of the on-premise software and the cloud-based service in such a way that the on-premise software and the cloud-based service significantly affect each other.
- Entity B’s marketing materials support a conclusion that the arrangement is for a combined solution rather than separate product or service offerings.

Construction Ahead — Accounting for Cloud Conversion (“Switching”) Rights in Software License Arrangements or Modifications

There is currently diversity in practice related to the accounting for software license arrangements or modifications that give the customer the right to switch from an on-premise software license to SaaS. Typically, the functionality of the SaaS is substantially the same as that of the on-premise software. Such arrangements or modifications include the following:

- Options provided at contract inception (at the customer’s election) to switch from an on-premise software license to SaaS.
- Contract modifications that result in the immediate switch from an on-premise software license to SaaS.
- Contract modifications that add an option to switch (at the customer’s election) from an on-premise software license to SaaS.

On May 8, 2019, the FASB decided to add the issue described above to the EITF’s agenda. Since additional guidance related to these arrangements may be forthcoming, entities that engage in these transactions should consider consulting with their auditors and accounting advisers and monitor any future developments.

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9 For discussion of another issue related to the same EITF project, see Construction Ahead in Section 12.6.1.
12.4 Identifying the Nature of the License

Legacy 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 legacy 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 legacy 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.

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**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.

**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 12.5.

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.

<table>
<thead>
<tr>
<th>ASC 606-10</th>
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<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
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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 12.4.1 and 12.4.2 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:

### Step 2: Identify the performance obligations.

- **License is distinct.** Account for the license as a performance obligation.
  - **Is the only consideration in the form of a sales- or usage-based royalty?**
    - Yes: Recognize revenue at the later of performance or when subsequent sales or usage occurs.
    - No: **Does the IP have significant stand-alone functionality?**
      - Yes: Functional IP (right-to-use) license – recognize revenue at a point in time.\(^{10}\)
      - No: Symbolic IP (right-to-access) license – recognize revenue over time.
- **License is not distinct.** Combine two or more promised goods or services.
  - If license is predominant: Do not use license guidance.
  - If license is not predominant: **Recognize revenue at the later of**

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**Connecting the Dots — 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 above, and to not assume that certain types of licenses should always be accounted for in a similar manner.

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\(^{10}\) For further discussion of a limited exception, see Section 12.4.1.
12.4.1 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 to functional IP. Examples of licenses to functional IP could include software, drug compounds and formulas, and completed media content (such as films, television shows, or music).

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.

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).

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.” That is because additional goods or services provided to the customer (e.g., updates and customization services) are typically promised goods or services that would not meet the criterion in ASC 606-10-55-62(a).
The following examples in ASC 606 illustrate the identification of functional IP:

**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.

**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.

**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 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.

**55-373** 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.
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.

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.

Example 61A — Right to Use Intellectual Property

Case A — License Is the Only Promise in the Contract

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.

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.
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

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.

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.

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)

55-3991 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.

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.

Generally, the nature of a license to functional IP that is distinct will provide an entity's customer with the right to use the entity's IP, which results in the entity's recognition of revenue at the point in time at which control of the license is transferred to the customer. However, there are situations in which an entity grants a license to functional IP that is transferred at contract inception but also promises to provide ongoing services that are not distinct from the license (i.e., the license and ongoing services are combined into a single performance obligation).

It is **not** acceptable for an entity to recognize revenue at the point in time at which a license to functional IP is granted when the revenue is related to a single performance obligation to (1) grant the license and (2) perform ongoing substantive services that are not distinct from the license. ASC 606-10-55-57 states:

> 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.

Although a license to functional IP provides the customer with a right to use the entity's IP as it exists at a point in time, the presence of an ongoing substantive service that is not distinct from the license indicates that the customer cannot continue to benefit from the license without the ongoing service. In addition, the entity's performance obligation is not fully satisfied upon transfer of the license because the entity has promised to provide an ongoing substantive service that is not separable from the license. That is, the license to the functional IP and the ongoing service are inputs into a combined item. Therefore, the nature of the entity's performance obligation involves continuing to provide the customer with an ongoing service over time. Because the entity does not fully satisfy its performance obligation upon transferring the license to the customer, it is not appropriate to recognize revenue for the single performance obligation at that point in time.
12.4.2 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. 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 to the customer.

Connecting the Dots — Ongoing Activities

As noted in paragraphs BC62 through BC65 of ASU 2016-10, ASC 606 contains no guidance requiring the entity to promise or expect to provide ongoing activities to maintain or support the IP. That is, if the customer has acquired a license to symbolic IP, the license is a right to access IP regardless of whether the entity expects to undertake activities to maintain the IP. An example of this may be the right to a license to a retired sports team’s name or logo. By contrast, under IFRS 15, an entity’s determination of whether a license is a right-to-use rather than a right-to-access license is based on whether the underlying IP is significantly affected by the entity’s ongoing activities. While this is a difference between U.S. GAAP and IFRS Standards, the FASB decided that the amendments in ASU 2016-10 would improve the operability of the licensing guidance. For more discussion on differences between U.S. GAAP and IFRS Standards, refer to Appendix A.
As noted in paragraph BC72 of ASU 2016-10, many right-to-access licenses “may constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer in accordance with paragraph 606-10-25-14(b) (for example, a series of distinct periods [month, quarter, year] of access).” See Section 5.3.3 for a discussion about the application of the series guidance.

A right-to-access license is transferred to the customer (and thus, revenue is recognized) over the shorter of the contractual term or the remaining economic life of the IP. Therefore, if an entity provides a customer with a perpetual license to symbolic IP, the entity will need to estimate the remaining economic life of the IP to determine the appropriate period over which to recognize revenue.

The following examples in ASC 606 illustrate the identification of symbolic IP:

**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.

**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.
   b. Subparagraph superseded by Accounting Standards Update No. 2016-10.
   c. Subparagraph superseded by Accounting Standards Update No. 2016-10.

**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.
### ASC 606-10 (continued)

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-385</td>
<td>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.</td>
</tr>
</tbody>
</table>
| 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.  
  b. Subparagraph superseded by Accounting Standards Update No. 2016-10.  
  c. Subparagraph superseded by Accounting Standards Update No. 2016-10. |
| 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. |
| 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. |

#### Example 61 — Access to Intellectual Property

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-395</td>
<td>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.</td>
</tr>
<tr>
<td>55-396</td>
<td>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.</td>
</tr>
</tbody>
</table>
| 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).  
  b. Subparagraph superseded by Accounting Standards Update No. 2016-10.  
  c. Subparagraph superseded by Accounting Standards Update No. 2016-10. |
Chapter 12 — Licensing

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.

**Connecting the Dots — Brand Name and Customer List — Airline Industry**

Airlines with large loyalty programs frequently enter into agreements with a co-branded credit card partner in which mileage credits and other consideration (e.g., award travel, upgrades, bag fee waivers, lounge access) are sold to a financial institution. The mileage credits are then issued to the financial institution's credit card customers, who are also airline loyalty members, as they make purchases on their co-branded credit card. In these arrangements, the financial institution will typically make an up-front payment to the airline for advance purchases of mileage credit and future services to be provided under the co-branded contract. The "advance services" include the financial institution's receiving direct access to the airline's customer list. When viewed from the airline's perspective, these co-branded agreements include two customers: the financial institution and the credit card holder. The credit card holder is included as a customer because of the mileage credits the holder will earn under its loyalty agreement.

Considerations related to the application of ASC 606 to these arrangements are discussed below.

**Performance Obligations**

Airline entities with these arrangements will need to carefully evaluate the terms of the agreements to properly identify and evaluate the promised goods or services that will be transferred to the customer(s). The significant performance obligations in a co-branded agreement might include (1) the airline's sale of the mileage credits to the financial institution and (2) the right transferred by the airline to the financial institution that allows the financial institution to access the airline's customer list and brand. Use of the airline's brand and access to the airline's customer list would typically be combined as a separate performance obligation since the financial institution would use both in its marketing efforts directed at the airline's customers to increase its credit card business. For example, from the perspective of the financial institution, access to only the airline's brand would have minimal value without access to the airline's customer list since the ability to target a common demographic of airline loyalty members is valuable to a financial institution. Further, access to the customer list without the brand would have limited value since the airline customers are induced to enter into an agreement with the financial institution by means of offers provided through the airline brand. Therefore, the combined right to access an airline's brand and customer list would generally be considered "highly interdependent or highly interrelated" under ASC 606-10-25-21(c). In addition, in the airline industry, it would be uncommon for an airline to separately sell the right to access its brand and customer list outside of a co-branded agreement.
For a discussion about identifying performance obligations in other co-branded credit card arrangements, see Section 5.3.2.3.2.

**Allocation of Transaction Price and Revenue Recognition**

In accordance with ASC 606-10-55-54, the right to access the airline’s customer list and brand is generally viewed as a right of the financial institution to access the airline's IP. ASC 606-10-55-58 distinguishes between (1) functional IP (the right to use an entity's IP, which promise is fulfilled at a point in time) and (2) symbolic IP (the right to access an entity's IP, which promise is fulfilled over time). The right to access the airline's customer list and brand over a contractual period represents symbolic IP since the use of the brand and customer list is beneficial to the financial institution as a result of the financial institution's continued association with the airline.

As noted above, the other significant performance obligation in a co-branded arrangement represents the sale of the mileage credits to the financial institution. The financial institution will typically transfer the mileage credits to its own customers as the co-branded credits cards are used. The airline's performance obligation would then be satisfied at a point in time upon the redemption of miles by credit card holders. Thus, the two performance obligations in a co-branded arrangement have different revenue recognition patterns since the performance obligation to provide mileage credits is satisfied at a point in time (when the mileage credits are redeemed by credit card holders) while the performance obligation to give the financial institution the right to access the airline's brand and customer list is satisfied over the period of the co-branded agreement. Recognition of the transaction price allocated to the mileage credits would be deferred until the later of when (1) the miles are used or (2) the miles expire (if applicable). In contrast, the transaction price allocated to the right to access the airline brand and customer list would be recognized over the period of the co-branded arrangement.

Further, the transaction price allocated to the symbolic IP in a co-branded arrangement is variable since most of the payments from the financial institution to the airline are dependent on the successful acquisition of new credit card holders and subsequent use of the card by the cardholders (which results in the payment of fees from the financial institution to the airline). Therefore, the airline would recognize revenue in accordance with the sales- or usage-based royalty guidance in ASC 606-10-55-65.

**12.4.3 Additional Flowchart 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.
12.5 Transfer of Control and Recognition

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, especially those related to software that is delivered electronically.

### 12.5.1 Electronic Delivery of Software

Examples 12-14 through 12-16 below discuss the transfer of control in arrangements involving electronically delivered software.

**Example 12-14**

**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.

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, X can reasonably conclude that control of the licenses for all five modules is transferred to B on January 1, 20X5.

**Example 12-15**

**Assessing When Control Is Transferred to the Customer When the License Requires an Access Code or Product Key**

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.

Entity X may not need to deliver the access code or product key to the customer to conclude that control of the software license has been transferred to the customer. 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]
Example 12-15 (continued)

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, the license term has begun, and the customer has a current right to request and receive the access code or product key, 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.

However, 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.

Example 12-16

Assessing When Control Is Transferred to the Customer in a Hosting Arrangement

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.

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.
- Y has made the access code available to X at any time on demand.

Therefore, assuming that no other indicators affecting the transfer of control are present, Y can reasonably conclude that control of the software license is transferred to X when the license term and hosting service begin. As a result, (1) 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 (2) the transaction price allocated to the hosting service is recognized over time.
12.5.2 When Control Is Transferred in Reseller Arrangements

Reseller arrangements in which a reseller purchases software from a software provider (the vendor) and then resells the software to end users are common in the software industry. In these situations, the reseller is often the vendor’s customer (rather than the end user). ASC 606-10-55-58C provides that revenue cannot be recognized from a license of IP before both (1) an entity provides a copy of the IP to a customer and (2) the period during which the customer can use and benefit from the IP has begun. Questions arise about when revenue can be recognized when sales of IP are made to resellers (e.g., distributors) rather than end users.

Example 12-17

On March 15, 20X0, Vendor A enters into a reseller arrangement with Reseller B that immediately permits B to resell 1,000 licenses of A’s software (a form of functional IP) for a nonrefundable up-front fee of $200,000. Reseller B plans to resell the functional IP to end users and will provide all set-up and maintenance services directly to the end users. There is no expectation that A will undertake activities to substantively change the functionality of the IP, and there are no promised goods or services in the contract other than the license to the functional IP. Also on March 15, 20X0, A ships to B a master copy of the software; B receives the master copy on April 1, 20X0, and can use it to replicate the software for resale. Vendor A also makes the software available for download on March 15, 20X0; however, B intends to use the master copy rather than the downloaded version to replicate the software for resale.

Vendor A should recognize revenue on March 15, 20X0. As noted in ASC 606-10-55-58C, control of IP cannot be transferred (and revenue cannot be recognized) before (1) the “entity provides (or otherwise makes available) a copy of the [IP] to the customer” and (2) 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 IP. In a reseller arrangement, the customer is not using the functionality of the software; rather, the customer will benefit from the software through the ability to resell the software. Although B intends to use the master copy to replicate the software, the software is made available to B on March 15, 20X0, which is also when B could begin reselling the software. Therefore, on March 15, 20X0, it would be appropriate for A to recognize the nonrefundable fee of $200,000 as revenue.

12.5.3 Recognition When a License Is Not Distinct From Other Goods or Services

If an entity determines that a license is not distinct and should therefore be combined with other goods or 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 the following:

- 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.
- The license is the predominant part of that combined 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. Rather, the transaction price would be recognized as revenue as the combined performance obligation (five-year license plus two-year service agreement) is satisfied. In this case, the timing of revenue recognition would be determined on the basis of the promised good or service that is transferred over the longer period (i.e., the five-year license).

12.6 License Renewals and Modifications

Renewals of and modifications to rights granted in a license arrangement occur frequently. Entities should consider the nature and provisions of license renewals and modifications when determining the appropriate accounting treatment. In addition, the discussions in this section should be considered in conjunction with those in Chapter 9 on contract modifications.

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 in paragraph BC50(a) of ASU 2016-10 that “when two parties enter into a contract to renew (or extend the license period of) a license, the renewal contract is not combined with the original license contract unless [one or more of] the criteria in paragraph 606-10-25-9 [on combining contracts] have been met.” 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:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 59 — Right to Use Intellectual Property</strong></td>
</tr>
<tr>
<td><strong>Case A — Initial License</strong></td>
</tr>
<tr>
<td><strong>55-389</strong> 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.</td>
</tr>
</tbody>
</table>
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.

12.6.1 Early Renewal of a Term-Based License

In conjunction with a term-based license, entities often offer customers a renewal option under which a customer can renew the contract and extend the period over which the customer has the right to use the licensed IP. In many cases, the customer may exercise its option to renew the license before the end of the initial license term. Although the customer may already be using the licensed IP, revenue attributable to the renewed license cannot be recognized until the beginning of the renewal period.

Example 12-18

Entity P enters into a three-year license agreement with Customer B under which B licenses software from P. The license includes three years of PCS (e.g., upgrades, bug fixes, and support). In exchange for the license and PCS, B pays P total consideration of $2,700, which consists of a $1,500 up-front payment for the license and annual installment payments of $400 for PCS payable at the end of each year. The contract states that B may extend the license for one-year terms at any point during the three-year license term for additional consideration.

Other relevant information includes the following:

- Entity P has concluded that the software license and PCS are distinct performance obligations.
- The contract amounts reflect each performance obligation’s stand-alone selling price.
- The software being licensed is functional IP, and the license gives B the right to use the software. As a result, P concludes that revenue allocated to the license should be recognized at the point in time that the customer obtains control of the license, which is assumed to be at contract inception.
- The PCS is determined to be a stand-ready obligation that is satisfied by P ratably over the PCS term.
- The initial contract does not include a material right.
Example 12-18 (continued)

At the end of year 2, B elects to extend the license for an additional year (i.e., the total license term would extend from three years to four years) in exchange for an additional $900 of consideration. Entity P determines that the additional license and PCS are priced at their respective stand-alone selling prices ($500 for the one-year term license and $400 for one year of PCS) and that the additional one-year term license and associated PCS are distinct performance obligations.

Entity P cannot recognize revenue allocated to the one-year renewal of the license granted to B before the expiration of the initial three-year license term.

In accordance with ASC 606-10-25-12, the contract extension is accounted for as a separate contract since the added goods and services (i.e., term license and PCS) are distinct and priced at their respective stand-alone selling prices. Although the customer already has the software subject to the one-year extension, the addition of one year to the right-to-use license creates a new distinct license that is transferred to the customer at the beginning of the extension period. ASC 606-10-55-58C states that an entity cannot recognize revenue from a license of IP before both of the following:

• The “entity provides (or otherwise makes available) a copy of the [IP] to the customer.”
• “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 [IP].”

ASC 606-10-55-58C further notes that an entity is not permitted to recognize revenue before the beginning of the license period even if the customer receives a copy of the IP before the beginning of the license period. Specifically, an entity is precluded from recognizing revenue from a license renewal before the beginning of the renewal period.

In accordance with the guidance in ASC 606-10-55-58C, P is precluded from recognizing the consideration allocated to the one-year term license (i.e., $500) until the beginning of year 4 (i.e., upon the expiration of the initial license term and beginning of the renewal period). If B prepays the $900 before the beginning of the renewal period, P would recognize that amount as a contract liability. At the beginning of year 4, P would start recognizing the $400 of consideration allocated to the additional year of PCS ratably over year 4.

Example 12-19

Assume the same facts as in Example 12-18, except that the additional consideration paid by B to extend the license for a year is $600 instead of $900 (i.e., the additional license and PCS are not priced at their stand-alone selling prices, which are $500 and $400, respectively). At the time of the extension, P is still entitled to $400 for the remaining year of PCS it must provide B under the original contract.

In accordance with ASC 606-10-25-13(a), P would account for the early renewal (which is a form of a contract modification) as if it were a termination of the original contract and the creation of a new contract. Entity P would combine the additional consideration of $600 with the consideration promised by B under the original contract and not yet recognized as revenue by P (i.e., $400) and allocate the resulting sum to the remaining performance obligations under the modified contract. At the time of the modification, the three-year term license under the original contract had already been transferred to the customer along with two years of PCS. Consequently, one year of PCS still must be transferred under the original contract along with a one-year term license and an additional year of PCS, both of which were added as a result of the modification. The combined consideration of $1,000 ($600 + $400) would be allocated to the remaining performance obligations as follows:
Example 12-19 (continued)

<table>
<thead>
<tr>
<th></th>
<th>Stand-Alone Selling Price</th>
<th>Relative Stand-Alone Selling Price</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-year term license</td>
<td>$ 500</td>
<td>38.5%</td>
<td>$ 385</td>
</tr>
<tr>
<td>Two years of PCS</td>
<td>$400 per year</td>
<td>61.5%</td>
<td>$615</td>
</tr>
<tr>
<td>Total</td>
<td>$1,300</td>
<td>100.0%</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Even though the modification is accounted for as if it were a termination of the existing contract and the creation of a new contract, the modification does not alter the original license term. That is, the modification does not change the original three-year term license to a two-year term license. Rather, the modification adds a one-year term license that begins after the expiration of the original three-year term license and requires P to allocate the consideration between the added one-year term license and the remaining two years of PCS. At the beginning of year 4, in a manner consistent with Example 12-18, P would recognize $385 immediately upon the transfer of the one-year right-to-use license to B. Further, P would start recognizing the $615 allocated to the PCS ratably at the beginning of year 3 (the time of the modification).

Construction Ahead — Accounting for Modifications of Software License Agreements That Include a Renewal and Additional Rights

There is currently diversity in practice related to the accounting for modifications of software license agreements that both (1) add new licenses and (2) extend or renew a license that was part of the original contract. Specifically, some stakeholders believe that it is unclear whether the renewal guidance should be applied to certain modifications.

On May 8, 2019, the Board decided to add the issue described above to the EITF’s agenda. Because additional guidance related to these arrangements may be forthcoming, entities that engage in these transactions should consider consulting with their auditors and accounting advisers and monitor any future developments.

12.6.2 Extension of a Right-to-Access License Agreement

Regardless of whether a modification to renew or extend a license is associated with a right to use IP or a right to access IP, the modification framework in ASC 606-10-25-12 and 25-13 should be applied. Example 12-20 below illustrates the accounting for the extension of a right-to-access license agreement.

Example 12-20

Entity X and Customer Y enter into a license agreement under which Y is provided the right to access X’s IP for three years for $3 million. After one year, X and Y agree to extend the contract for an additional two years for $1.8 million.

Assume that X has concluded that the additional two years of access to its IP are distinct from access to its IP over the initial three-year period.

Entity X should apply the modification guidance in ASC 606-10-25-12 and 25-13 (see Section 9.2). Entity X should first determine whether the contract modification meets the criteria in ASC 606-10-25-12 to be accounted for as a separate contract.

11 For discussion of another issue related to the same EITF project, see Construction Ahead in Section 12.3.6.
In this example, the criterion in ASC 606-10-25-12(a) is met because the scope of the contract is increased by two years and the right to access X’s IP over that period is considered distinct in accordance with ASC 606-10-25-19 through 25-22. The determination that the right to access IP for an additional two years provides additional goods or services that are distinct is consistent with paragraph BC72 of ASU 2016-10, which states that in many right-to-access license arrangements, “the license may constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer in accordance with paragraph 606-10-25-14(b) (for example, a series of distinct periods [month, quarter, year] of access).”

Entity X must also consider whether the contract modification meets the criterion in ASC 606-10-25-12(b), which requires the modification to increase the price of the contract “by an amount of consideration that reflects the entity’s standalone selling prices of the additional promised goods or services.” If X determines that the contract modification increases the price of the contract by an amount of consideration that reflects the entity’s stand-alone selling price for the added rights to access the IP, the modification will be accounted for as a separate contract. 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.

If X determines that the contract modification does not increase the price of the contract by an amount of consideration that reflects the entity’s stand-alone selling price of the added rights to access the IP, the modification will be accounted for in accordance with ASC 606-10-25-13. Since the added rights to access the IP are considered distinct, X should account for the modification as a termination of the existing contract and the creation of a new contract in accordance with ASC 606-10-25-13(a).

Regardless of whether the contract modification is accounted for as a separate contract or as a termination of the original contract and the creation of a new contract, the modification should be accounted for prospectively. That is, no cumulative-effect adjustment should be recorded as a result of the modification.

If X determines that the $1.8 million represents the stand-alone selling price of the right to access its IP during the extension period, X would account for the right to access its IP in years 4 and 5 as a separate contract. Revenue for each year of the five-year arrangement would be recorded as follows:

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

If X determines that the $1.8 million does not represent the stand-alone selling price of the right to access its IP during the extension period, X would account for the modification as a termination of the original contract and the creation of a new contract. Revenue for each year of the five-year arrangement would then be recorded as follows:

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$950,000</td>
<td>$950,000</td>
<td>$950,000</td>
<td>$950,000</td>
</tr>
</tbody>
</table>
12.6.3 Renewals of PCS in a Software Arrangement

It is common for an entity’s software contract with a customer to include both a software license and PCS for a defined term (e.g., 12 months). In some cases, the software license is perpetual, or the term of the license is greater than the initial PCS term. After the initial PCS term, the customer may be entitled to renew the PCS at a renewal rate stated in the contract. Questions have arisen about how to account for (1) a reinstatement of PCS after the initial PCS term has lapsed (see Section 12.6.3.1 below) and (2) an option to renew PCS when it is not distinct from a perpetual software license (see Section 12.6.3.2).

12.6.3.1 Reinstatement of PCS After Customer Lapse

As noted in Section 12.6.3 above, an entity could grant a license to software on a perpetual basis or for a term greater than the initial PCS term, with an option to renew the PCS at a stated renewal rate. If the customer does not elect to renew the PCS, the entity may not have an obligation (explicit or implied) to provide PCS to the customer after the initial PCS term. While the customer does not have the right to receive software updates or support if it does not renew the PCS, the customer retains the right to use the software in its then current state.

Although the entity does not have a contractual, legal, or implied obligation to provide PCS to the customer if the customer does not renew the PCS, the entity may continue to provide PCS as a courtesy to the customer. However, if there is no enforceable contract during the lapse period, the customer might not have the legal right to retain and use the benefits, including any software updates or enhancements, provided by the PCS during the lapse period. If the customer renews the PCS after the initial PCS term has lapsed, the entity may require the customer to pay a reinstatement fee equal to the amount that the customer would have paid for the PCS during the lapse period in addition to the fee for the remaining renewal period.

To account for a contract with a customer to reinstate PCS, an entity can use either of the following two methods depending on the nature of the PCS:

- **Cumulative catch-up method (“Alternative A”)** — Upon the customer’s reinstatement of the PCS, the entity should record a cumulative adjustment to revenue. Under this alternative, the fee paid by the customer to reinstate the PCS should be allocated to both the PCS provided during the lapse period (software updates and enhancements provided as a courtesy during the lapse period if control of these items is transferred to the customer upon reinstatement of the PCS) and the future services to be provided over the remaining PCS term after the reinstatement. The amount allocated to the software updates and enhancements provided during the lapse period is recognized immediately because control is transferred at the point in time at which the PCS is reinstated. The amount allocated to future services is recognized over time as these services are provided.

- **Prospective method (“Alternative B”)** — Upon the customer’s reinstatement of the PCS, the entity should allocate the consideration in the contract (i.e., the reinstatement fee equal to what the customer would have paid during the lapse period and the fee for additional PCS) to the remaining months of PCS to be provided to the customer. This amount is recognized over time as the services are provided.

12 The alternatives outlined in this section are premised on the assumption that the entity does not have an implied obligation to provide PCS during the lapse period.
We believe that Alternative A is more appropriate if control over any updates or software enhancements already received by the customer (i.e., the right to legally retain bug fixes, updates, and enhancements that were provided during the lapse period) is transferred to the customer only at the point in time at which the PCS is reinstated. Under Alternative A, no revenue should be recognized during the lapse period because there is no contract with the customer. However, upon the customer’s reinstatement of the PCS, the entity should recognize a cumulative adjustment to revenue in an amount that corresponds to the rights transferred to the customer upon reinstatement (which, under the facts of this scenario, is the reinstatement fee equal to the amount that the customer would have paid for the PCS during the lapse period). Although the customer may receive PCS during the lapse period, the customer does not have the legal right to retain the benefits from the PCS during this period; however, the rights to retain and use the benefits, updates, and enhancements are transferred to the customer if the customer renews the PCS. As noted above, the total fee charged to the customer includes a reinstatement fee equal to the amount that the customer would have paid for the PCS during the lapse period and an amount related to the PCS to be provided under the remaining PCS term. Therefore, the fee paid by the customer upon renewal is related to both the PCS still to be provided under the contract and the PCS provided during the lapse period.

Because the nature of PCS can differ among entities, additional consideration may be required if the entity does not provide upgrades, enhancements, or bug fixes as part of the PCS (e.g., when the PCS includes only support). In such cases, Alternative B may be more appropriate because the customer may not receive incremental rights upon reinstatement.

**Example 12-21**

Entity V provides hospitals with communications solutions, which consist of hardware, software, and PCS for the software. On January 1, 20X1, V enters into a contract with Customer C to grant C a perpetual license to V’s software and 12 months of PCS. The contract states that the PCS may be renewed on an annual basis for $1,200. Entity V concludes that the $1,200 represents the stand-alone selling price of the PCS. In addition, V concludes that its obligation to provide PCS is a stand ready obligation that provides C with a benefit ratably over the contract term.

At the end of the initial 12-month term, C does not elect to renew the PCS and therefore does not make any further payment. Although V does not have an explicit or implicit obligation to provide any services, V continues to provide the PCS, including updates and enhancements to the software, as a courtesy to C because V expects that C will eventually reinstate the PCS. However, C does not have the legal right to retain or use the benefits of the updates or enhancements to the software until it reinstates the PCS.

On April 1, 20X2 (i.e., three months after the PCS has lapsed), C reinstates the PCS by paying V $1,200, of which $300 represents a reinstatement fee equal to the amount that C would have paid for the PCS during the lapse period. The new PCS term expires on December 31, 20X2. The $1,200 fee paid by C is intended to compensate V for the three months of PCS provided during the lapse period and the remaining nine months of PCS to be provided over the remaining period of the new PCS term. Entity V concludes that control of the rights to retain and use the benefits provided by the PCS (i.e., the right to retain or use the enhanced and updated software) during the three-month lapse period is immediately transferred to the customer once the PCS is reinstated.

Upon reinstatement of the PCS, V should recognize $300 as revenue immediately because this represents the value of the rights that are transferred to C immediately upon reinstatement of the PCS. Entity V would then recognize $900 as revenue over the remaining contract period ending on December 31, 20X2.
12.6.3.2 Options to Renew PCS When PCS Is Not Distinct From a Perpetual Software License

Example 12-22 below illustrates the identification of material rights in a contract involving renewable PCS that is not distinct from a perpetual software license.

Example 12-22

On January 1, 20X9, Company LN enters into a contract with a customer to transfer a perpetual antivirus software license and provide unspecified software updates as PCS for one year in exchange for an up-front, nonrefundable fee of $3,000, which is the standard price paid by all new customers. Company LN has concluded that the software license and PCS are not distinct because the functionality and utility of the software are highly dependent on the PCS and vice versa. The updates significantly modify the functionality of the software by permitting the software to protect the customer from a significant number of additional viruses that the software did not protect against previously. The updates are also integral to maintaining the utility of the software license to the customer. Therefore, the transfer of a perpetual antivirus software license and the obligation to provide PCS constitute a single performance obligation.

At the end of the year, the customer has an option to renew the PCS on an annual basis for $300. The customer may exercise this option each year on an indefinite basis. The customer is expected to renew the PCS for four additional years after the first year of the contract.

The annual renewal options exercisable by the customer each represent a material right in LN's contract. Since the license is not distinct (separable) from the PCS, the customer is effectively renewing the single performance obligation (the combined license and PCS) each year even though the software that is being provided is in the form of a perpetual license.

Therefore, each annual renewal option represents a material right because the renewal options enable LN's customer to renew the contract at a price that is lower than the amount that new customers are typically charged (i.e., only $300 is required to renew as compared with the $3,000 that new customers must pay). Because the material rights are accounted for as separate performance obligations, LN allocates the total transaction consideration of $3,000 for the first year to the identified performance obligations (services for the first-year contract and the material rights) on a relative stand-alone selling price basis. As described in ASC 606-10-55-45, as a practical alternative to estimating the stand-alone selling price of the renewal options, LN may be able to allocate the transaction price to the renewal options (i.e., the material rights) “by reference to the goods or services expected to be provided and the corresponding expected consideration.” In accordance with ASC 606-10-55-42, the amount allocated to each annual renewal option (i.e., the material rights) would be recognized (1) as LN provides the service to which the renewal option is related or (2) when the renewal options expire.

12.7 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.
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).

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 generally 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 (under the assumption that the associated performance obligation has been satisfied or partially satisfied).

The sales- or usage-based royalty exception only applies if the royalty is associated with a license of IP that is the predominant item. For example, if the royalty is associated with a franchise license and other services provided to a franchisee, the exception would apply if the customer can reasonably expect the franchise license to have significantly more value than the services. Example 60 in ASC 606, which is reproduced below, illustrates a situation in which a license of IP would be considered the predominant item to which a contract’s sales-based royalty is related.
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.

12.7.1 Whether to Apply the Sales- or Usage-Based Royalty Exception to Only Part of the Royalties

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 FASB clarified in ASU 2016-10 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. However, as explained in paragraph BC75(a) of the ASU, “this amendment does not affect the requirement to allocate fees due from a sales-based or usage-based royalty to the performance obligations (or distinct goods or services) in the contract to which the royalty relates, regardless of the constraint model the entity is required to apply.” For an illustration of how an entity would comply with the allocation requirement, see Example 35, Case B, in ASC 606-10-55-275 through 55-279, which is reproduced in Section 7.5.1.

In ASU 2016-10, the FASB also clarified that the sales- or usage-based royalty exception applies when the license is the predominant item (regardless of whether the license is distinct or combined with other goods or services as a single performance obligation) in relation to other nonlicense goods or services. That is, an entity either applies the sales- or usage-based royalty exception in its entirety (if the license to IP is predominant) or applies the general variable consideration guidance (if the license to IP is not predominant). Further, the FASB clarified in paragraph BC75(b) of the ASU that the sales- or usage-based royalty exception would also apply in “situations in which no single license is the predominant item to which the royalty relates but the royalty predominantly relates to two or more licenses promised in the contract.” However, ASC 606 does not define the term “predominant.” As a result, an entity will need to exercise judgment when determining whether the license to IP is predominant.
12.7.2 Interaction of Sales- or Usage-Based Royalty Exception With Measuring Progress Toward Satisfaction of a Performance Obligation

When applying the sales- or usage-based royalty exception, an entity typically 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 or all of the revenue as the subsequent sales or usage occurs.

ASC 606-10-55-65 specifies that revenue from 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 a performance obligation (i.e., criterion (b)). Royalty arrangements can differ greatly between entities and between contracts. Further, the timing of the recognition of royalties can depend on the nature of the underlying IP (i.e., right to access or right to use) as well as the structure of the royalty payments. Therefore, the determination of whether revenue from royalties should be deferred will depend on an analysis of the specific facts and circumstances. For example, if the performance obligation to which the royalties are related is a right-to-access license of IP, it will often be helpful to consider whether the structure of the royalty payments appropriately depicts progress toward satisfying the 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 for an entity to identify an appropriate measure of progress toward complete satisfaction of its obligation (e.g., providing access to the entity's IP) in accordance with ASC 606-10-25-31. The entity 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 the entity determined by applying the identified measure of progress. If so, the entity 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.
Example 12-23 below illustrates the accounting for royalties related to a right-to-access license under various scenarios.

**Example 12-23**

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.

Consider the following scenarios:

- **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.

**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 could 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.
Example 12-24 below illustrates the accounting for variable royalty rates over the term of a right-to-access license.

**Example 12-24**

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. Entity S could 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. For example, if S is able to reasonably estimate the royalties, it could apply a blended rate to recognize revenue if doing so would result in an appropriate measure of progress and would not result in recognizing revenue before the underlying sales or usage occurs.

Example 12-25 below illustrates the accounting for variable royalty rates paid in exchange for a right-to-use license.

**Example 12-25**

An entity enters into a contract to provide a customer with a noncancelable license to the entity's IP. There are no other promised goods or services in the contract. 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.

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).” Because the license is a right-to-use license for which control is transferred at the inception of the contract, the “later” of the two conditions is met when the subsequent sales occur.
12.7.3 Scope of the Sales- or Usage-Based Royalty Exception

12.7.3.1 Sale of IP Versus License of IP in Exchange for a Sales- or Usage-Based Royalty

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.

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. In addition, the sales- or usage-based royalty exception should be applied to a contract that is a licensing arrangement in form even if the arrangement is an in-substance sale of IP. That is, the legal form of the transaction will determine which revenue accounting guidance is applied (see Section 12.2.2).

Example 12-26

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 12-27

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.

Entity X should not apply the sales- or usage-based royalty exception in ASC 606-10-55-65. Rather, 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.
12.7.3.2 Whether Application of the Sales- or Usage-Based Royalty Exception Is Optional

The guidance in ASC 606-10-55-65 must be applied whenever a license to IP that is the predominant item is subject to a sales- or usage-based royalty. That is, applying the exception is not optional when the consideration due in a licensing arrangement is in the form of a sales- or usage-based royalty. Consider the examples below.

**Example 12-28**

Entity LN, a professional basketball team, licenses its logo to a manufacturer of sports apparel and receives a royalty payment for each item of sports apparel sold. Entity LN has historical experience that is highly predictive of the amount of royalties that it expects to receive.

The sales- or usage-based royalty exception in ASC 606-10-55-65 states that revenue should be 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-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).” The application of the sales- or usage-based royalty exception is not optional, and LN would be precluded from recognizing the royalty revenue until the later of (1) the actual sale of the sports apparel or (2) LN's satisfaction of the performance obligation to which the sales- or usage-based royalty is related.

**Example 12-29**

Entity S licenses its software (i.e., functional IP) to an OEM, which then integrates S's software with its own software for inclusion in hardware devices (e.g., computers, tablets, and smart devices) to be sold to end users. Entity S sells 5,000 licenses to the OEM for $10 per license (i.e., $50,000 in total consideration) that is paid at contract inception. In addition, S provides the OEM with 5,000 activation keys, each of which allows the OEM to download S's software for integration with the OEM's software to be included in one hardware device. The license agreement allows the OEM to acquire additional software licenses for $10 per license by requesting additional activation keys, which S readily provides to the OEM. Entity S has concluded that providing additional license keys to the OEM does not transfer any additional rights not already controlled by the OEM (see Section 12.3.3).

The OEM can return any activation keys that are paid for but not used to download and integrate the software for inclusion in the OEM's devices. The OEM will receive a refund of $10 per license for any activation keys returned.

Because S's consideration for the transfer of the licensed software (i.e., functional IP) is contingent on the OEM's subsequent usage, S must apply the sales- or usage-based royalty exception described in ASC 606-10-55-65. It would not be appropriate for S to recognize revenue on the sale of the license with the right of return before the OEM's subsequent usage.

Although the OEM has paid for the activation keys at contract inception, because the amounts are refundable to the extent that the OEM does not use the IP by integrating it with the OEM's software to be included in hardware devices, the consideration is in the form of a sales- or usage-based royalty. Entity S would therefore be prohibited from recognizing revenue until the subsequent sale or usage of the IP occurs (in accordance with 606-10-55-65(a)). That is, it would not be appropriate for S to estimate and constrain the amount of consideration to which it expects to be entitled and recognize such at the time the initial 5,000 licenses are transferred to the OEM.
12.7.3.3 Fixed 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).

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 any 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.

12.7.4 Recognition of Sales-Based Royalties When Information Is 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. Provided that the related performance obligation has been satisfied or partially satisfied, 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.

Example 12-30

Entity LN 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, LN receives royalties on the basis of the number of computers sold that include the licensed software. Upon delivery of the software to B, LN satisfies the performance obligation to which the sales-based royalty was allocated. Thereafter, LN receives quarterly sales data in arrears, which allow it to calculate the royalty payments due under the license.

Entity LN should 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.

In this scenario, royalties should be recognized for sales made by B up to the end of LN's reporting period on the basis of sales data received before LN's financial statements are issued or available to be issued. If necessary, LN 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.
Example 12-30 (continued)

This conclusion is consistent with the following view expressed by then OCA Deputy Chief Accountant Wesley Bricker in his June 9, 2016, speech at the 35th Annual SEC and Financial Reporting Institute Conference:

The standard setters did not provide a lagged reporting exception with the new standard. Accordingly, I believe companies should apply the sales- and usage-based royalty guidance as specified in the new standard. The reporting, which may require estimation of royalty usage, should be supported by appropriate internal accounting controls.

12.7.5 Sales- or Usage-Based Royalties With a Minimum Guarantee

Sometimes, the sales- or usage-based royalty may be subject to a minimum guarantee, which establishes a floor for the amount of consideration to be paid to the entity. The sales- or usage-based royalty exception applies only when the consideration due under the licensing agreement is variable and the variability is directly related to sales or usage of the underlying IP. That is, the exception does not apply to any fixed consideration in a licensing arrangement.

12.7.5.1 Application of the Sales- or Usage-Based Royalty Exception to Guaranteed Minimum Royalties Related to Functional IP

If there are no other performance obligations, a minimum guarantee related to functional IP (i.e., a right-to-use license) should be recognized as revenue at the point in time that the entity transfers control of the license to the customer. Any royalties that exceed the minimum guarantee should be recognized as the subsequent sales or usage related to the IP occurs, in accordance with ASC 606-10-55-65.

Example 12-31

Entity LH enters into a five-year license agreement with Customer MC under which MC can air all of the existing seasons of a TV show in exchange for royalties from MC’s sales and usage of the IP. In addition, the contract contains a minimum guarantee of $1 million per year. The existing seasons of the TV show have stand-alone functionality and thus represent functional IP.

Ignoring potential effects of financing, LH should recognize the total minimum guarantee of $5 million for the contract when control of the functional IP is transferred to the customer and the license period begins. This is because (1) the $5 million is fixed as a result of the minimum guarantee and (2) the underlying IP (i.e., the TV show) is functional (revenue is recognized at a point in time). Additional royalties that exceed the $1 million minimum guarantee in any year should be recognized as the subsequent sales and usage occur.

The above issue is addressed in Implementation Q&A 60 (compiled from previously issued TRG Agenda Papers 58 and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.
12.7.5.2 Application of the Sales- or Usage-Based Royalty Exception to Guaranteed Minimum Royalties Related to Symbolic IP

For licenses of symbolic IP, the new revenue standard does not prescribe a one-size-fits-all model for recognizing revenue over time in situations in which a sales- or usage-based royalty contract with a customer includes a minimum guaranteed amount of consideration. As discussed at the November 2016 TRG meeting, the following are three acceptable approaches for recognizing revenue in those situations:

- **Approach A** — Recognize revenue as the subsequent sales or usage occurs in accordance with ASC 606-10-55-65 if an entity expects that the total royalties will exceed the minimum guarantee. This approach would be appropriate only if the estimated sales- or usage-based royalties are expected to exceed the minimum guarantee.

- **Approach B** — Estimate the transaction price (as fixed consideration plus expected royalties to be earned over the license term) and recognize revenue over time by using an appropriate measure of progress, but limit cumulative revenue recognized to the cumulative royalties in excess of the minimum guarantee. Like Approach A, this approach would be appropriate only if the estimated sales- or usage-based royalties are expected to exceed the minimum guarantee. Under this approach, an entity will need to periodically revisit its estimate of the total consideration (fixed and variable) and update its measure of progress accordingly (which may result in a cumulative adjustment to revenue).

- **Approach C** — Recognize the minimum guarantee over time by using an appropriate measure of progress over the license period, and recognize incremental royalties in excess of the minimum guarantee as the subsequent sales or usage related to those incremental royalties occurs.

An entity should evaluate its facts and circumstances to determine which method under the standard appropriately depicts its progress toward completion. In addition, entities should consider providing appropriate disclosures to help users of their financial statements understand which approach is being applied. Examples of such disclosures include the key judgments the entity applied in selecting a measure of progress for recognizing revenue from a license of symbolic IP.

The above issue is addressed in *Implementation Q&A 59* (compiled from previously issued TRG Agenda Papers 58 and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

12.7.6 Allocating Fixed Consideration and Sales- or Usage-Based Royalties in a Licensing Arrangement With More Than One Performance Obligation

Complexities related to the allocation of the transaction price to multiple performance obligations may arise when licensing contracts include a combination of fixed consideration and royalties subject to the sales- or usage-based royalty exception. As discussed in Section 12.7.5.2 above, there are several acceptable approaches to accounting for a licensing arrangement that includes both a minimum guaranteed amount and a sales- or usage-based royalty for any sales or usage in excess of that minimum amount in a license of symbolic IP.
Chapter 12 — Licensing

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.

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.
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.

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).

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.

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.

Example 57 — Franchise Rights

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

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.
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

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.

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.

Licensing

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.

b. Subparagraph superseded by Accounting Standards Update No. 2016-10.
c. Subparagraph superseded by Accounting Standards Update No. 2016-10.
ASC 606-10 (continued)

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.

Examples 12-32 through 12-34 below illustrate possible approaches that may be appropriate when a licensing arrangement includes (1) fixed consideration and sales- or usage-based royalties and (2) more than one performance obligation.

Example 12-32

Entity X, a cable TV network company, enters into a four-year contract with Entity Y on January 1, 201X. The contract gives Y an exclusive license, including digital streaming rights (within specific territories), to a preexisting library of X's historical content in addition to any new content that becomes available during the four-year term. Entity X determines that there are two distinct performance obligations in accordance with ASC 606-10-25-19 through 25-22 as follows:

- A license of the preexisting library of content (i.e., the historical content) transferred to Y at the outset of the contract. Entity X determines that this is a right-to-use license of IP for which revenue is recognized at a point in time in accordance with ASC 606-10-55-63.
- A license for any new content that is transferred to Y as it becomes available throughout the duration of the contract. Entity X determines that the obligation to update the license arrangement to include new content is a stand-ready obligation to provide updates to Y over the license term. Entity X concludes that it will satisfy this obligation ratably over the four-year license term.

Entity Y is required to pay X a royalty fee of $2 per subscriber per month over the contract term, subject to a minimum guaranteed amount of $10 million. Entity X estimates that over the contract term, it is probable that X will be entitled to total royalties of $30 million. In addition, X determines that (1) the stand-alone selling price of the license of historical content is $12 million (40 percent of the total estimated transaction price) and (2) the stand-alone selling price of the license of new content is $18 million (60 percent of the total estimated transaction price). The number of subscribers to Y's service in year 1 is such that X is entitled to a royalty of $13 million.

Entity X determines that there are at least two acceptable approaches ("Approach A" and "Approach B") to allocating the $10 million guaranteed minimum fee and the $2 per subscriber royalty fee between the two performance obligations in the contract.

Whichever approach is adopted, as discussed below, X will need to consider whether it is required to constrain the amount of revenue recognized in accordance with ASC 606-10-32-11 and apply the sales- or usage-based royalty exception in ASC 606-10-55-65.
Example 12-32 (continued)

Revenue Recognition Based on Initial Allocation of Fixed and Variable Consideration

**Approach A**

Under Approach A, X allocates both the fixed and variable consideration to each performance obligation on the basis of the relative stand-alone selling prices of the historical and new content as follows:

<table>
<thead>
<tr>
<th></th>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of initial estimate of total royalties ($30 million) to the performance obligations on a relative stand-alone selling price basis</td>
<td>$ 12</td>
<td>$ 18</td>
<td>$ 30</td>
</tr>
<tr>
<td>Allocation of guaranteed minimum ($10 million) to the performance obligations on a relative stand-alone selling price basis</td>
<td>4</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Allocation of estimated variable consideration in excess of the guaranteed minimum ($20 million) to the performance obligations on a relative stand-alone selling price basis</td>
<td>$ 8</td>
<td>$ 12</td>
<td>$ 20</td>
</tr>
</tbody>
</table>

In year 1, X recognizes revenue as follows:

- $4 million of the guaranteed minimum revenue allocated to the historical content is recognized upon the initial transfer of the historical content to Y.
- $1.5 million of the guaranteed minimum revenue is allocated to and recognized for the new content ($6 million ÷ 4 years of license term).
- The royalty payments received in excess of the $10 million guaranteed revenue are subject to the guidance in ASC 606-10-55-65 on recognizing revenue related to sales- or usage-based royalties. Therefore, $3 million ($13 million of royalties owed for year 1 less the $10 million of guaranteed minimum revenue) is allocated on a relative stand-alone selling price basis. Accordingly, $1.2 million is allocated to and recognized for the historical content, and $1.8 million is allocated to and recognized for the new content.

Thus, the total revenue recognized in year 1 under Approach A is $8.5 million, as illustrated in the table below.

<table>
<thead>
<tr>
<th></th>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognized in year 1 from guaranteed minimum</td>
<td>$ 4.0</td>
<td>$ 1.5</td>
<td>$ 5.5</td>
</tr>
<tr>
<td>Revenue recognized in year 1 from variable consideration</td>
<td>1.2</td>
<td>1.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Total revenue recognized in year 1</td>
<td>$ 5.2</td>
<td>$ 3.3</td>
<td>$ 8.5</td>
</tr>
</tbody>
</table>

Note that the royalties in excess of the guaranteed minimum that are allocated to the new content in year 1 ($1.8 million) do not need to be restricted in accordance with ASC 606-10-55-65 because the total revenue recognized for the new content ($3.3 million) is less than the amount corresponding to the measure of progress ($18 million ÷ 4 years of license term = $4.5 million).
Example 12-32 (continued)

**Approach B**

Under Approach B, X allocates the consideration on a first in, first out basis. Accordingly, the guaranteed minimum and estimated royalties are first allocated to the historical content and then to the new content, as illustrated in the table below. Note that the estimated royalties are subject to the constraint 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 (see Section 6.3.3 for further discussion of this objective).

<table>
<thead>
<tr>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of initial estimate of total royalties ($30 million) to the performance obligations on a relative stand-alone selling price basis</td>
<td>$ 12</td>
<td>$ 18</td>
</tr>
<tr>
<td>Allocation of guaranteed minimum to the performance obligations</td>
<td>$ 10</td>
<td>$ —</td>
</tr>
<tr>
<td>Allocation of estimated variable consideration to the performance obligations</td>
<td>$ 2</td>
<td>$ 18</td>
</tr>
</tbody>
</table>

In year 1, X recognizes revenue as follows:

- $10 million of the guaranteed minimum allocated to the historical content is recognized upon the initial transfer of the historical content to Y.
- $2 million of the variable consideration allocated to the historical content is recognized when the first $2 million of royalties earned in excess of the guaranteed $10 million becomes payable by Y.
- While on a pro rata basis, X would recognize $4.5 million ($18 million ÷ 4 years of license term) with respect to the new content, X is able to recognize only $1 million with respect to the new content ($13 million of royalties owed for year 1 less the $12 million recognized with respect to the historical content) since the variable consideration is subject to the restriction in ASC 606-10-55-65 on recognizing revenue related to sales- or usage-based royalties.

Thus, the total revenue recognized in year 1 under Approach B is $13 million, as illustrated in the table below.

<table>
<thead>
<tr>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognized in year 1 from guaranteed minimum</td>
<td>$ 10</td>
<td>$ —</td>
</tr>
<tr>
<td>Revenue recognized in year 1 from variable consideration</td>
<td>$ 2</td>
<td>$ 1</td>
</tr>
<tr>
<td>Total revenue recognized in year 1</td>
<td>$ 12</td>
<td>$ 1</td>
</tr>
</tbody>
</table>
Example 12-32 (continued)

Revenue Recognition Based on Updated Allocation of Fixed and Variable Consideration

Each of the approaches discussed above is affected differently by a change in the estimate of royalties to which the entity expects to be entitled. The impact of any change in estimate under each approach should be carefully considered in accordance with the guidance on estimating and constraining variable consideration, whose objective is to include some or all of an amount of variable consideration estimated 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 (see Section 6.3.3 for further discussion of this objective).

Suppose that after one year, X updates the transaction price in accordance with ASC 606-10-32-14 and concludes that it is probable that X will be entitled to total royalties of only $20 million over the four-year contract term as a result of changing market conditions (i.e., $10 million less than the original estimated transaction price). Under ASC 606-10-32-43, X is required to reallocate the transaction price to each performance obligation on the same basis as at contract inception. Also assume that in year 2, only $2 million in additional royalties is earned and payable to X (total consideration of $15 million has been earned to date, and there is an expectation that an additional $5 million will be received for the remaining contract term).

The effect of the updated expectations on revenue recognized in year 2 under each approach is discussed below.

Approach A

Under Approach A, X updates the allocation of the fixed and variable consideration to each performance obligation on the basis of the relative stand-alone selling prices of the historical and new content as follows:

<table>
<thead>
<tr>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Updated estimate of total royalties ($20 million) allocated to the performance obligations on a relative stand-alone selling price basis</td>
<td>$8</td>
<td>$12</td>
</tr>
<tr>
<td>Allocation of guaranteed minimum ($10 million) to the performance obligations on a relative stand-alone selling price basis</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Allocation of estimated variable consideration ($10 million) to the performance obligations on a relative stand-alone selling price basis</td>
<td>4</td>
<td>6</td>
</tr>
</tbody>
</table>

Accordingly, revenue is recognized as follows:

<table>
<thead>
<tr>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative fixed fees recognized in year 2</td>
<td>$4.0</td>
<td>$3.0</td>
</tr>
<tr>
<td>Cumulative royalties recognized in year 2</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Cumulative revenue (fixed fees and royalties) recognized in year 2</td>
<td>6.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Revenue recognized in year 1 (under Approach A as previously illustrated)</td>
<td>5.2</td>
<td>3.3</td>
</tr>
<tr>
<td>Additional revenue recognized in year 2</td>
<td>$0.8</td>
<td>$2.7</td>
</tr>
</tbody>
</table>
Example 12-32 (continued)

Note that the royalties allocated to the new content ($3 million) are not restricted in accordance with ASC 606-10-55-65 because the total revenue recognized for new content ($6 million) does not exceed the amount corresponding to the measure of progress ([$12 million ÷ 4 years of license term] × 2 years) = $6 million).

**Approach B**

Under Approach B, X updates the allocation of the fixed and variable consideration to each performance obligation on the basis of the relative stand-alone selling prices of the historical and new content as follows:

<table>
<thead>
<tr>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Updated estimate of total royalties ($20 million) allocated to the performance obligations on a relative stand-alone selling price basis</td>
<td>$8</td>
<td>$12</td>
</tr>
<tr>
<td>Allocation of guaranteed minimum ($10 million) to the performance obligations</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Allocation of estimated variable consideration ($10 million) to the performance obligations</td>
<td>—</td>
<td>$10</td>
</tr>
</tbody>
</table>

As a result of the updated estimate of the transaction price, X is limited in recognizing additional revenue in year 2 when it reallocates the total expected consideration between the historical and new content. Revenue is recognized as follows:

<table>
<thead>
<tr>
<th>Historical Content ($ in millions)</th>
<th>New Content ($ in millions)</th>
<th>Total ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative fixed fees recognized in year 2</td>
<td>$8.0</td>
<td>$2.0</td>
</tr>
<tr>
<td>Cumulative royalties recognized in year 2</td>
<td>—</td>
<td>5.0</td>
</tr>
<tr>
<td>ASC 606-10-55-65 limitation on new content</td>
<td>—</td>
<td>(1.0)</td>
</tr>
<tr>
<td>Cumulative revenue (fixed fees and royalties) recognized in year 2</td>
<td>8.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Revenue recognized in year 1 (under Approach B as previously illustrated)</td>
<td>12.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Additional revenue recognized in year 2</td>
<td>$ (4.0)</td>
<td>$5.0</td>
</tr>
</tbody>
</table>

Note that the royalties allocated to the new content ($5 million) are restricted under Approach B in accordance with ASC 606-10-55-65 because the total revenue otherwise recognized for the new content ($7 million) would exceed the amount corresponding to the measure of progress ([$12 million ÷ 4 years of license term] × 2 years = $6 million). Consequently, $1 million of the royalties received in year 2 would need to be deferred.

As noted in the tables above, Approach A and Approach B have different accounting outcomes for both the consideration recognized as revenue in year 1 of the agreement and the changes in subsequent years to the estimated consideration to which X expects to be entitled. Care should be taken in the election of a policy, and careful evaluation of the objective behind constraining estimates of variable consideration should guide this election.
Example 12-33

Entity K, a biotechnology company, enters into a contract with Customer C to provide a license of functional IP as well as R&D services. As a result of the late stage of development of the IP and other factors, K has concluded that the license and R&D services are distinct performance obligations. The contract consideration includes (1) an up-front payment ($30 million), (2) royalties of 8 percent of future sales (estimated to be $50 million), and (3) a reimbursement for the R&D services at cost plus a fixed margin (estimated to be $20 million). Entity K has concluded that the license to IP is predominant in the arrangement.

Entity K has estimated the stand-alone selling prices of the performance obligations as follows:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Stand-Alone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$ 80 million</td>
</tr>
<tr>
<td>R&amp;D services</td>
<td>$ 20 million</td>
</tr>
</tbody>
</table>

Because the sales- or usage-based royalty exception is a recognition constraint (applied as part of step 5 of the new revenue model), K could still consider the sales-based royalties in the estimated transaction price to be allocated even though they are subject to the sales- or usage-based royalty exception (and are constrained at contract inception). That is, K might reasonably conclude that it can allocate the royalties (estimated to be $50 million) together with the up-front fee of $30 million (a total expected amount of $80 million) entirely to the license since such allocation would be consistent with the stand-alone selling price of the license and, therefore, with the allocation objective in ASC 606-10-32-28 and ASC 606-10-32-40. Entity K could also allocate the $20 million to which it expects to be entitled for performing the R&D services entirely to the R&D services performance obligation. Such allocation would also be consistent with the allocation objective because the consideration to which K expects to be entitled as it performs the R&D services represents the stand-alone selling price for those services. The approach described herein is consistent with the approach illustrated in Example 35, Case A, of ASC 606.

As a result of the above allocations, K would recognize (1) revenue of $30 million when the license is transferred at contract inception ($80 million total consideration allocated to the license, of which $50 million is constrained because of the sales- or usage-based royalty exception) and (2) revenue for the R&D services at the contractual reimbursement rate as services are performed. Additional revenue related to the transfer of the license would be recognized as royalties become due (i.e., once sales associated with the licensed IP occur).

Example 12-34

Assume the same facts as in Example 12-33 above, except that the R&D services are reimbursed by Customer C at cost with no margin (estimated to be $15 million). Since K would not typically provide R&D services on a stand-alone basis for cost (i.e., with no margin), use of the allocation approach described in Example 12-33 would not result in an allocation that is consistent with the allocation objective in ASC 606-10-32-28 and ASC 606-10-32-40. Consequently, K would not be able to use the same approach in this situation.

If K continues to believe that the royalties are entirely related to the license, K could allocate the total expected transaction price ($95 million) to the performance obligations on a relative stand-alone selling price basis as follows:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Stand-Alone Selling Price</th>
<th>Relative Allocation</th>
<th>Allocation of Estimated Contract Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$ 80 million</td>
<td>80%</td>
<td>$ 76 million</td>
</tr>
<tr>
<td>R&amp;D services</td>
<td>$ 20 million</td>
<td>20%</td>
<td>$ 19 million</td>
</tr>
<tr>
<td>Total</td>
<td>$ 100 million</td>
<td>100%</td>
<td>$ 95 million</td>
</tr>
</tbody>
</table>
Example 12-34 (continued)

As the table illustrates, this approach would result in the allocation of $76 million to the license and $19 million to the R&D services. If K concludes that the royalties are entirely related to the license (i.e., the criteria in ASC 606-10-32-40 are met), it would recognize revenue of $26 million when the license is transferred at contract inception (the $76 million allocated transaction price less the $50 million that is constrained because of the sales- or usage-based royalty exception). Further, K would recognize (1) revenue of $19 million allocated to the R&D services as the R&D services are performed by using a single measure of progress and (2) additional revenue related to the transfer of the license as royalties become due (i.e., once sales associated with the licensed IP occur).

12.7.7 Applicability of the Sales- or Usage-Based Royalty Exception to Agents

The guidance in ASC 606-10-55-65 discusses situations in which an entity transfers a license of IP to a customer in exchange for a sales- or usage-based royalty. However, in some cases, an entity may be compensated in the form of a sales- or usage-based royalty for services that are directly related to a license of IP, but the entity itself is not licensing the IP because it is not the owner of the IP. Examples 12-35 through 12-37 below illustrate situations in which an entity provides services in exchange for a sales- or usage-based royalty that is directly related to a license of IP.

Example 12-35

Company X, acting as a film distributor (agent), enters into arrangements to distribute filmed media content to theaters or other outlets (e.g., video on demand service providers) to make the content available for viewing by various audiences. The filmed content was produced and is owned by another entity (the “licensor”). In such arrangements, X acts as an agent between the licensor and the customer (e.g., a theater or another outlet). In exchange for performing the agency services, X is entitled to variable consideration based on the licensor’s royalties underlying the sales related to the licensed IP (e.g., ticket sales). The licensor’s earnings and, in turn, the fees earned by X are directly tied to the sales of the licensed IP.

Example 12-36

Company Y, acting as a talent agent, finds roles for its clients in films or other theatrical productions. Each of Y’s clients is paid a stated royalty percentage based on the sales or usage of the film or production (i.e., the IP), and Y’s commission is equal to a stated percentage of the royalty earned by the client. Company Y does not own or control the film or production at any point, and neither does Y’s client; rather, Y’s ability to generate commissions depends on how the film or production is monetized. Accordingly, the client’s earnings and, in turn, the commissions earned by Y are directly tied to the sales or usage of the licensed IP.

Example 12-37

Company Z, acting as an agent, identifies licensees to enter into contracts with Z’s clients (i.e., licensors). Each of Z’s clients is paid a stated royalty percentage based on the sales and usage of the IP licensed by the licensee (e.g., a college logo on merchandise), and Z’s commission is a stated percentage of the royalty earned by its client. Company Z does not own or control the IP at any point; rather, Z’s ability to generate commissions is dependent on the existence of its client’s IP. Accordingly, the client’s earnings and, in turn, the commissions earned by Z are directly tied to the sales or usage of the licensed IP.

In each of the examples above, it is acceptable for the agent to apply the sales- or usage-based royalty exception in ASC 606-10-55-65 to account for the fees or commissions earned by the agent.
Generally, the sales- or usage-based royalty exception may be applied only in limited situations by the licensor (i.e., when an entity licenses its IP and is compensated in the form of a royalty that varies on the basis of the customer's sales or usage of the licensed IP). However, there are situations in which an entity may apply the sales- or usage-based royalty exception even though it does not own the IP or act as the principal in the arrangement (i.e., it does not control or license the IP). When determining whether it is appropriate to apply the sales- or usage-based royalty exception in these situations, entities should consider the nature of the services being provided to the customer and use judgment to determine whether such services are directly related to the IP that is being licensed. That is, if the revenue to be received is based on a sales- or usage-based royalty from a license of IP and the service provided by the entity is directly related to that IP, it would be acceptable to apply the royalty exception in ASC 606-10-55-65.

This conclusion is consistent with the discussion in paragraph BC415 of ASU 2014-09, which explains that if the exception did not apply, an entity would be required to “report, throughout the life of the contract, significant adjustments to the amount of revenue recognized at inception of the contract as a result of changes in circumstances, even though those changes in circumstances are not related to the entity's performance.” On the basis of discussion with the FASB staff, we understand that the Board did not intend to limit the exception to owners of the IP (i.e., the logic for providing the exception would apply equally to the owners of the IP and others receiving a portion of a royalty for services directly related to the license of the IP).

If the services being provided are not directly linked to the underlying IP being licensed or the entity's compensation does not vary on the basis of the sales or usage of the licensed IP, it would not be appropriate to apply the sales- or usage-based royalty exception.
Chapter 13 — Contract Costs

13.1 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 13.2), 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 13.3).

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 IFRS Standards. The boards also wanted to improve consistency in the application of certain cost guidance. For example, under legacy U.S. GAAP, entities may not consistently capitalize direct and incremental costs associated with obtaining a contract. Although certain legacy 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 (unless a practical expedient is elected).

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**

Legacy guidance under U.S. GAAP does not contain a comprehensive cost framework for either costs of obtaining a contract or costs of fulfilling 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 of obtaining 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, legacy 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 legacy 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 16 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 determine whether the guidance will affect them.
### 13.2 Costs of Obtaining a Contract

<table>
<thead>
<tr>
<th>ASC 340-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-2</strong> 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).</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>ASC 340-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1</strong> 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.</td>
</tr>
<tr>
<td><strong>25-2</strong> 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).</td>
</tr>
<tr>
<td><strong>25-3</strong> 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.</td>
</tr>
</tbody>
</table>
The flowchart below illustrates the process that entities should use in applying the guidance in ASC 340-40-25-1 through 25-3 to determine the treatment of costs of obtaining a contract with a customer.
13.2.1 General Considerations for Identifying Incremental Costs of Obtaining a Contract With a Customer

ASC 340-40-25-2 states that 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).” Application of this guidance requires an entity to identify those costs that are incurred (i.e., accrued) as a direct result of obtaining a contract with a customer. An entity should apply existing guidance outside of the new revenue standard to determine whether a liability should be recognized as a result of obtaining a contract with a customer. Upon determining that a liability needs to be recorded, the entity should determine whether the related costs were incurred because, and only because, a contract with a customer was obtained.

In many circumstances, it may be clear whether particular costs are costs that an entity incurs to obtain a contract. For example, if an entity incurs a commission liability solely as a result of obtaining a contract with customer, the commission would be an incremental cost incurred to obtain a contract with a customer. However, in other circumstances, an entity may need to exercise judgment and consider existing accounting policies for liability accruals when determining whether a cost is incurred in connection with obtaining a contract with a customer. If the determination of whether a cost has been incurred is affected by other factors (i.e., factors in addition to obtaining a contract with a customer), an entity will need to take additional considerations into account when assessing whether a cost is an incremental cost associated with obtaining a contract with a customer.

Examples 1 and 2 in ASC 340-40 illustrate how to identify incremental costs of obtaining a contract:

<table>
<thead>
<tr>
<th>ASC 340-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 1 — Incremental Costs of Obtaining a Contract</strong></td>
</tr>
<tr>
<td><strong>55-2</strong> 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:</td>
</tr>
<tr>
<td>External legal fees for due diligence</td>
</tr>
<tr>
<td>Travel costs to deliver proposal</td>
</tr>
<tr>
<td>Commissions to sales employees</td>
</tr>
<tr>
<td><strong>Total costs incurred</strong></td>
</tr>
<tr>
<td><strong>55-3</strong> 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.</td>
</tr>
<tr>
<td><strong>55-4</strong> 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.</td>
</tr>
</tbody>
</table>
Example 2 — Costs That Give Rise to an Asset

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

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.

The FASB staff noted that the accounting for sales commissions is generally straightforward in situations in which (1) the commission is a fixed amount or a percentage of contract value and (2) the contract is not expected to be (or cannot be) renewed. However, if compensation plans or other costs incurred are complex, it may be difficult to determine which costs are truly incremental and to estimate the period of amortization related to them.

Examples of complex scenarios include:

- Plans with significant fringe benefits.
- Salaries based on the employee’s prior-year signed contracts.
- Commissions paid in different periods or to multiple employees for the sale of the same contract.
- Commissions based on the number of contracts the salesperson has obtained during a specific period.
- Legal and travel costs incurred in the process of obtaining a contract.
- Anticipated contract renewals.

Stakeholders expressed concerns that the term “incremental” could lead to broad interpretations of the types of costs that would qualify as costs to be capitalized under the new revenue standard. In response to those concerns, the FASB staff noted the following:

- An entity should consider whether costs would have been incurred if the customer (or the entity) decided that it would not enter into the contract just as the parties were about to sign the contract. If the costs (e.g., the legal costs of drafting the contract) would have been incurred even though the contract was not executed, the costs would not be incremental costs of obtaining a contract.
- When an entity is identifying incremental costs incurred to obtain a contract, it may be important for the entity to first consider guidance outside of the new revenue standard on determining whether and, if so, when a liability has been incurred. That is, other guidance will generally determine when a cost has been incurred, while ASC 340-40 provides guidance on determining whether costs should be capitalized or expensed.
When sales commissions are paid to different levels of employees, the new revenue standard does not differentiate among the commissions on the basis of the employees’ respective functions or titles. For example, if an entity's commission policy on new contracts was to pay 10 percent sales commission to the sales employee, 5 percent to the sales manager, and 3 percent to the regional sales manager, all of the commissions are viewed as incremental because the commissions would not have been incurred if the contract had not been obtained.

Entities should continue to refer to legacy U.S. GAAP on liability recognition to determine whether and, if so, when a liability needs to be recorded in connection with a contract with a customer. Therefore, an entity should initially apply the specific guidance on determining the recognition and measurement of the liability (e.g., commissions, payroll taxes, 401(k) match). If the entity recognizes a liability, only then should the entity determine whether to record the related debit as an asset or as an expense.

The new standard requires costs to be incremental rather than both direct and incremental as they were under legacy U.S. GAAP (e.g., on loan origination and insurance policy acquisition). Accordingly, this difference may lead to a broader pool of costs that are subject to capitalization (i.e., entities may be required to capitalize certain costs in accordance with the new standard that they would not have capitalized under legacy U.S. GAAP if they had elected a capitalization policy).

However, entities need to use judgment to determine whether certain costs, such as commissions paid to multiple employees for the signing of a contract, are truly incremental. Entities should apply additional skepticism to understand whether an employee's compensation (i.e., commissions or bonus) — particularly for individuals in different positions in the organization and employees who are ranked higher in an organization — is related solely to executed contracts or is also influenced by other factors or metrics (e.g., employee general performance or customer satisfaction ratings). Only those costs that are incremental (e.g., costs that resulted from obtaining the contract) may be capitalized (as long as other asset recognition criteria are met).

The table below outlines the views detailed in TRG Agenda Paper 57 and broadly summarized in Q&A 78 of the FASB staff’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”). Quoted text is from TRG Agenda Paper 57.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Example/Question</th>
<th>Views Discussed</th>
<th>View Selected by FASB Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed employee salaries</td>
<td><strong>Example 1:</strong> An entity pays an employee an annual salary of $100,000. The employee's salary is based upon the employee's prior-year signed contracts and the employee's projected signed contracts for the current year. The employee's salary will not change based on the current year's actual signed contracts; however, salary in future years likely will be impacted by the current year's actual signed contracts. What amount, if any, should the entity record as an asset for incremental costs to obtain a contract during the year?</td>
<td><strong>View A:</strong> “Determine what portion of the employee's salary is related to sales projections and allocate that portion of the salary as an incremental cost to obtain a contract.” <strong>View B:</strong> “Do not capitalize any portion of the employee's salary as an incremental cost to obtain a contract. The costs are not incremental costs to any contract because the costs would have been incurred regardless of the employee's signed contracts in the current year.”</td>
<td>“[N]one of the employee's salary should be capitalized as an incremental cost to obtain a contract. . . . Whether the employee sells 100 contracts, 10 contracts, or no contracts, the employee is still only entitled to a fixed salary.” “[T]he objective of the requirements in [ASC] 340-40-25-1 is not to allocate costs that are associated in some manner with an entity's marketing and sales activity. The objective is to identify the incremental costs that an entity would not have incurred if the contract had not been obtained.”</td>
</tr>
</tbody>
</table>
### Example 2: An entity pays a 5% sales commission to its employees when they obtain a contract with a customer. An employee begins negotiating a contract with a prospective customer and the entity incurs $5,000 of legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a $500,000 contract and, as a result, the employee receives a $25,000 sales commission. What amount should the entity capitalize as an incremental cost to obtain the contract?

**View A:** “The entity should capitalize only $25,000 for the sales commission. Those costs are the only costs that are incremental costs to obtain the contract because the entity would not have incurred the costs if the contract had not been obtained.”

**View B:** “The entity should capitalize $30,000, which includes the sales commission, legal expenses, and travel expenses. The entity would not have been able to obtain the contract without incurring those expenses.”

**View A.** “[T]he sales commission is the only cost that the entity would not have incurred if the contract had not been obtained. While the entity incurs other costs that are necessary to facilitate a sale (such as legal, travel and many others), those costs would have been incurred even if the customer decided at the last moment not to execute the contract.”

Consider a similar situation in which an entity “incurs the same type of legal and travel expenses to negotiate a contract, but the customer decides not to enter into the contract right before the contract was to be signed by both parties. [T]he travel and legal expenses would still have been incurred even though the contract was not obtained. However, the commission would not have been incurred.”
<table>
<thead>
<tr>
<th>Topic</th>
<th>Example/Question</th>
<th>Views Discussed</th>
<th>View Selected by FASB Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timing of commission</td>
<td><strong>Example 3:</strong> An entity pays an employee a 4% sales commission on all of the employee’s signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2% of the total contract value) upon completion of the sale, and the remaining half of the commission (2% of the total contract value) in six months. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a sale of $50,000 at the beginning of year one. What amount should the entity capitalize as an incremental cost to obtain the contract?”</td>
<td><strong>View A:</strong> “Capitalize half of the commission ($1,000) and expense the other half of the commission ($1,000).”</td>
<td><strong>View B:</strong> “The commission is an incremental cost that relates specifically to the signed contract and the employee is entitled to the unpaid commission. The timing of payment does not impact whether the costs would have been incurred if the contract had not been obtained.”</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>View B:</strong> “Capitalize the entire commission ($2,000).”</td>
<td>“In this fact pattern, only the passage of time needs to occur for the entity to pay the second half of the commission. However, . . . there could be other fact patterns in which additional factors might impact the payment of a commission to an employee.” For example, an entity could make the second half of the commission contingent upon the employee’s selling additional services to the customer or upon the customer’s “completing a favorable satisfaction survey about its first six months of working with the entity.” Therefore, an “entity will need to assess its specific compensation plans to determine the appropriate accounting for incremental costs of obtaining a contract.”</td>
</tr>
</tbody>
</table>
Chapter 13 — Contract Costs

(Example continued)

<table>
<thead>
<tr>
<th>Topic</th>
<th>Example/Question</th>
<th>Views Discussed</th>
<th>View Selected by FASB Staff</th>
</tr>
</thead>
</table>
| Commissions paid to different levels of employees | **Example 4:** An entity’s salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager. Which commissions are incremental costs of obtaining a contract? | **View A:** “Only the commission paid to the salesperson is considered incremental because the salesperson obtained the contract.”  
**View B:** “Only the commissions paid to the salesperson and the manager are considered incremental because the other employee likely would have had no direct contact with the customer.”  
**View C:** “All of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained.” | **View C.** “The new revenue standard does not make a differentiation based on the function or title of the employee that receives the commission. It is the entity that decides which employee(s) are entitled to a commission directly as a result of entering into a contract.”  
“(It is possible that several commissions payments are incremental costs of obtaining the same contract. However, [stakeholders are encouraged] to ensure that each of the commissions are incremental costs of obtaining a contract with a customer, rather than variable compensation (for example, a bonus) that would not be incremental because it also relies on factors other than sales.” |

| Commission payments subject to a threshold | **Example 5:** An entity has a commission program that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. The breakdown is as follows:  
- 0-9 contracts . . . 0% commission  
- 10-19 contracts . . . 2% of value of contracts 1-19  
- 20+ contracts . . . 5% of value of contracts 1-20+  
Which commissions are incremental costs of obtaining a contract? | **View A:** “No amounts should be capitalized because the commission is not directly attributable to a specific contract.”  
**View B:** “The costs are incremental costs of obtaining a contract with a customer and, therefore, the costs should be capitalized.” | **View B.** Both the 2 percent commission and the 5 percent commission are incremental costs of obtaining a contract. “The entity would apply other GAAP to determine whether a liability for the commission payments should be recognized. When a liability is recognized, the entity would recognize a corresponding asset for the commissions. This is because the commissions are incremental costs of obtaining a contract with a customer. The entity has an obligation to pay commissions as a direct result of entering into contracts with customers. The fact that the entity’s program is based on a pool of contracts (versus a program in which the entity pays 3% for all contracts) does not change the fact that the commissions would not have been incurred if the entity did not obtain the contracts with those customers.” |
The above issue is addressed in Implementation Q&A 78 (compiled from previously issued TRG Agenda Papers 57 and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

13.2.2 Sales Commissions and Compensation Structures

Commissions are often cited as an example of an incremental cost incurred to obtain a contract. Acknowledging that it may be difficult for an entity to determine whether a commission paid was incremental to obtaining the new contract, the boards considered permitting a policy election consistent with legacy 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 Sections 14.6.3 and 14.7.4 for discussion of the presentation of contract costs in an entity’s classified balance sheet and income statement, respectively.

Some commission plans include substantive service conditions that need to be met before a commission associated with a contract (or group of contracts) is actually earned by the salesperson. In such cases, some or all of the sales commission may not be incremental costs incurred to obtain a contract with the customer since the costs were not actually incurred solely as a result of obtaining a contract with a customer. Rather, the costs were incurred as a result of obtaining a contract with a customer and the salesperson’s providing ongoing services to the entity for a substantive period.

A commission structure could have a service condition that is determined to be nonsubstantive. In such a case, the commission is likely to be an incremental cost incurred to obtain a contract with a customer if no other conditions need to be met for the salesperson to earn the commission. In other cases, a commission plan could include a service condition, but the reporting entity determines on the basis of the amount and structure of the commission payments that part of the entity’s commission obligation is an incremental cost incurred to obtain a contract with a customer (because it is not tied to a substantive service condition) while the rest of the commission is associated with ongoing services provided by the salesperson (because it is tied to a substantive service condition).

Sometimes, there may be other factors that affect the commission obligation, but the ultimate costs are still incremental costs incurred to obtain the contract. For example, a commission may be payable to a salesperson if a customer’s total purchases exceed a certain threshold regardless of whether the salesperson is employed when the threshold is met (i.e., there is no service condition). In these cases, although no liability may be recorded when the contract with the customer is obtained (because of the entity’s assessment of the customer’s likely purchases), if the customer’s purchases ultimately exceed the threshold and the commission is paid, the commission is an incremental cost of obtaining the contract. That is, the commission is a cost that the entity would not have incurred if the contract had not been obtained. This situation is economically similar to one involving a paid commission that is subject to clawback if the customer does not purchase a minimum quantity of goods or services.

Entities will need to carefully evaluate the facts and circumstances when factors other than just obtaining a contract with a customer affect the amount of a commission or other incurred costs. Entities should consider their existing policies on accruing costs when determining which costs are incremental costs incurred to obtain a contract with a customer.
Example 13-1

Entity A’s internal salespeople earn a commission based on a fixed percentage (4 percent) of sales invoiced to a customer. Half of the commission is paid when a contract with a customer is signed; the other half is paid after 12 months, but only if the salesperson is still employed by A. Entity A concludes that there is a substantive service period associated with the second commission payment, and A’s accounting policy is to accrue the remaining commission obligation ratably as the salesperson provides ongoing services to A.

Entity A enters into a three-year noncancelable service contract with a customer on January 1, 20X7. The total transaction price of $3 million is invoiced on January 1, 20X7. The salesperson receives a commission payment of 2 percent of the invoice amount ($60,000) when the contract is signed; the other half of the 4 percent commission will be paid after 12 months if the salesperson continues to be employed by A at that time. That is, if the salesperson is not employed by A on January 1, 20X8, the second commission payment will not be made. Entity A records a commission liability of $60,000 on January 1, 20X7, and accrues the second $60,000 commission obligation ratably over the 12-month period from January 1, 20X7, through December 31, 20X7.

Entity A concludes that only the first $60,000 is an incremental cost incurred to obtain a contract with a customer. Because there is a substantive service condition associated with the second $60,000 commission, A concludes that the additional cost is a compensation cost incurred in connection with the salesperson’s ongoing service to A. That is, the second $60,000 commission obligation was not incurred solely to obtain a contract with a customer but was incurred in connection with ongoing services provided by the salesperson.

If the salesperson would be paid the commission even if no longer employed, or if A otherwise concluded that the service condition was not substantive, the entire $120,000 would be an incremental cost incurred to obtain a contract and would be capitalized in accordance with ASC 340-40-25-1. Entities will need to exercise professional judgment when determining whether a service condition is substantive.

Because commission and compensation structures can vary significantly between entities, an entity should evaluate its specific facts and circumstances when determining which costs are incremental costs incurred to obtain a contract with a customer. Since 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).

Entities should 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.

In addition, 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 is related. That is, the asset should be amortized in a manner that reflects the benefit (i.e., revenue) generated from the asset. For further discussion, see Section 13.4.1.
The above issue is addressed in Implementation Q&As 67 through 75 (compiled from previously issued TRG Agenda Papers 23, 25, 57, and 60). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

13.2.2.1 Tiered Commissions

Commission plans for a specific employee that involve initial contracts and contract renewals might be established in such a way that (1) the commission is subject to a cumulative contract threshold and (2) commission rates change depending on the number (or cumulative value) of contracts signed. For instance, fixed or percentage commissions may commence or change once a specified threshold is achieved for the cumulative number or value of contracts. The examples below, which are adapted from examples considered by the FASB staff in TRG Agenda Paper 23, illustrate various cumulative threshold scenarios.

**Example 13-2**

Once a cumulative threshold number of contracts is reached, the entity pays commission on individual contracts as a percentage of the value of each contract in the manner shown in the table below.

<table>
<thead>
<tr>
<th>Number of Contracts Signed</th>
<th>Commission Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1–5</td>
<td>0% commission</td>
</tr>
<tr>
<td>6–10</td>
<td>3% of individual contract price</td>
</tr>
<tr>
<td>11 or more</td>
<td>5% of individual contract price</td>
</tr>
</tbody>
</table>

**Example 13-3**

Once a cumulative threshold value of contracts is reached, the entity pays commission on individual contracts as a percentage of the value of each contract in the manner shown in the table below.

<table>
<thead>
<tr>
<th>Value of Contracts Signed</th>
<th>Commission Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $1 million</td>
<td>0% commission</td>
</tr>
<tr>
<td>Next $4 million</td>
<td>3% of individual contract price</td>
</tr>
<tr>
<td>More than $5 million</td>
<td>5% of individual contract price</td>
</tr>
</tbody>
</table>
Chapter 13 — Contract Costs

Example 13-4

Once a cumulative threshold number of contracts is reached, the entity pays commission on the last contract as a percentage of the cumulative value of that contract and the preceding contracts in the manner shown in the table below, taking into account any commission already paid.

<table>
<thead>
<tr>
<th>Number of Contracts Signed</th>
<th>Commission Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1–5</td>
<td>0% commission</td>
</tr>
<tr>
<td>6</td>
<td>3% of value of contracts 1–6</td>
</tr>
<tr>
<td>7–10</td>
<td>0% commission</td>
</tr>
<tr>
<td>11 or more</td>
<td>5% of value of all contracts (including commission already paid on contracts 1–6)</td>
</tr>
</tbody>
</table>

Example 13-5

As shown in the table below, the entity pays the first commission when the first contract is signed. Subsequently, once a cumulative threshold number of contracts is reached, the entity pays a commission on the threshold contract that is greater than the commission paid on the initial contract and takes into account any commissions previously paid. In this example, it is assumed that the entity has no history of sales employees’ closing more than 15 new contracts in a period.

<table>
<thead>
<tr>
<th>Number of Contracts Signed</th>
<th>Commission Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>10</td>
<td>$ 5,000 cumulative commission (including $3,000 already paid)</td>
</tr>
<tr>
<td>15</td>
<td>$ 10,000 cumulative commission (including $5,000 already paid)</td>
</tr>
</tbody>
</table>

Assume that the commissions in all of the examples above are incremental costs incurred to obtain a contract that should be capitalized in accordance with ASC 340-40-25-1.

There are at least two acceptable approaches to determining which commissions are incremental to obtaining a contract in the scenarios described above. One approach (“Approach A”) would be to specifically attribute the incremental costs of each contract to that contract. For example, if no commission is paid until the fifth contract is signed, the commission would be attributed to only the fifth contract. Another approach (“Approach B”) would be to accrue commission for each contract on the basis of the average commission rate expected to be paid under the commission plan. For example, although a commission is paid only once the fifth contract is signed, the commission is earned, and would be accrued, as contracts 1 through 5 are signed. Entities should consider their historical policies for recording commission liabilities when determining which approach to apply.
Under the two alternative approaches, the entity in each of the illustrative examples above should account for the tiered commissions as follows:

- **Example 13-2:**
  - *Approach A* — When the 6th contract is signed, the entity should capitalize 3 percent of the price of that contract and successive contracts as an incremental cost of obtaining a contract until the 11th contract is signed, at which point the entity should capitalize 5 percent of the price of that contract and successive contracts.
  - *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that seven contracts, each valued at $10,000, will be signed and therefore the total estimated price of the 6th and 7th contract is $20,000, it estimates the total commission to be capitalized as $600 ($20,000 × 3% commission). Upon the signing of each $10,000 contract, the entity may capitalize $86 of commission ($600 total estimated commission ÷ the 7 expected contracts signed = $86 estimated commission per contract).

- **Example 13-3:**
  - *Approach A* — Upon the signing of the specific contract that results in the aggregate value of over $1 million in contract value, the entity should capitalize 3 percent of the price of that contract and successive contracts as an incremental cost of obtaining a contract until the $5 million aggregate value is reached, at which point the entity should capitalize 5 percent of the price of that contract and successive contracts.
  - *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that three contracts will be signed with an aggregate of $4 million in contract value (contract 1 is $1 million, contract 2 is $1 million, and contract 3 is $2 million), the entity will estimate $90,000 in commissions to be capitalized (($4,000,000 − $1,000,000) × 3% commission = $90,000). The entity may capitalize the relative value for each contract (contract 1 = $22,500 = [$1,000,000 ÷ $4,000,000] × $90,000; contract 2 = $22,500 = [$1,000,000 ÷ $4,000,000] × $90,000; and contract 3 = $45,000 = [$2,000,000 ÷ $4,000,000] × $90,000).

- **Example 13-4:**
  - *Approach A* — When the 6th contract is signed, the entity should capitalize 3 percent of the cumulative prices of contracts 1 through 6 as an incremental cost of obtaining the 6th contract. Similarly, when the 11th contract is signed, the entity should capitalize 5 percent of the cumulative prices of contracts 1 through 11 (less the 3 percent previously paid on contracts 1 through 6) as an incremental cost of obtaining the 11th contract. Further, the entity should capitalize 5 percent of the price of each successive contract (beyond the 11th contract) as an incremental cost of obtaining a contract.
  - *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that eight contracts will be signed and the estimated cumulative prices of contracts 1 through 6 will be $32,000, it will estimate $960 in commissions to be capitalized ($32,000 × 3% commission = $960). If the price of each contract is the same, the entity may capitalize $120 upon the signing of each contract ($960 total estimated commission ÷ the 8 expected contracts signed = $120 estimated commission per contract).
• Example 13-5:
  
  ○ **Approach A** — Once the initial contract is signed, the entity should capitalize $3,000 as an incremental cost of obtaining that contract. The entity would not capitalize any additional amounts when contracts 2 through 9 are signed because the next commission “tier” has not been met. Once the 10th contract is signed, the entity should capitalize an additional $2,000. Similarly, the entity would not capitalize any additional amounts when contracts 11 through 14 are signed and should capitalize an additional $5,000 once the 15th contract is signed.

  ○ **Approach B** — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that 11 contracts will be signed and the price of each contract is the same, it may capitalize $455 when each contract is signed ($5,000 ÷ the 11 contracts signed = $455 to be capitalized as the commission amount per contract).

The above issue is addressed in Implementation Q&A 69 (compiled from previously issued TRG Agenda Papers 23 and 25). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

### 13.2.2.2 Fringe Benefits

Example 13-6 below illustrates the determination of whether fringe benefits such as 401(k) match contributions associated with sales commissions should be capitalized as incremental costs of obtaining contracts with customers.

<table>
<thead>
<tr>
<th>Example 13-6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity C has a policy to match 401(k) contributions based on salaries paid to sales representatives, including sales commissions. These sales commissions are determined to meet the definition of incremental costs of obtaining contracts with customers in ASC 340-40-25-2 and are therefore capitalized in accordance with ASC 340-40-25-1.</td>
</tr>
<tr>
<td>When 401(k) match contributions (along with other fringe benefits) are attributed directly to sales commissions that are determined to be incremental costs of obtaining contracts with customers, the 401(k) match contributions also qualify as incremental costs of obtaining the contracts since such costs would not have been incurred if the contracts had not been obtained. However, incremental costs of obtaining contracts with customers would not include fringe benefits constituting an allocation of costs that would have been incurred regardless of whether a contract with a customer had been obtained.</td>
</tr>
</tbody>
</table>

The above issue is addressed in Implementation Q&A 74 (compiled from previously issued TRG Agenda Papers 23, 25, 57, and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

### 13.2.2.3 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, in December 2016, the FASB issued ASU 2016-20, which aligns the cost capitalization guidance in ASC 946 for advisers to both public funds and private funds (see Chapter 20).
13.2.3 Practical Expedient in ASC 340-40-25-4 for Expensing Contract Acquisition Costs

<table>
<thead>
<tr>
<th>ASC 340-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

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 (see Chapter 15 on disclosure requirements). In addition, the practical expedient should be applied consistently to contracts with similar characteristics and in similar circumstances.

### 13.2.3.1 Whether the Practical Expedient Must Be Applied to All Contracts

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 determine that different subsidiaries or business units have contracts with dissimilar characteristics or dissimilar circumstances.

### 13.2.3.2 Whether the Practical Expedient May Be Applied Selectively on a Contract-by-Contract or Cost-by-Cost Basis

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.

Further, an entity is not permitted to apply the practical expedient in ASC 340-40-25-4 to some costs attributable to performance obligations in a contract but not others. 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.
13.2.3.3 Practical Expedient Unavailable When the Amortization Period Is Greater Than One Year

Example 13-7 below illustrates a situation in which the practical expedient in ASC 340-40-25-4 would not be available.

<table>
<thead>
<tr>
<th>Example 13-7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity B enters into a contract with a customer to provide the following:</td>
</tr>
<tr>
<td>- Product X delivered at a point in time.</td>
</tr>
<tr>
<td>- Maintenance of Product X for one year.</td>
</tr>
<tr>
<td>- An extended warranty on Product X that covers years 2 and 3 (Product X comes with a one-year statutory warranty).</td>
</tr>
</tbody>
</table>

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 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 years 2 and 3). 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 (see Section 13.4.1.1).

13.2.3.4 Amortization Periods Slightly Greater Than One Year

As previously noted, an entity is precluded from using the practical expedient in ASC 340-40-25-4 if the amortization period of the asset that the entity otherwise would have recognized is greater than one year. This restriction applies even if the amortization period is only slightly greater than one year.

<table>
<thead>
<tr>
<th>Example 13-8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A enters into a noncancelable contract with a customer to provide marketing services for 13 months. A commission of $100 is earned by the salesperson in connection with A’s entering into the contract with the customer. The commission is determined to meet the definition of an incremental cost of obtaining the contract in ASC 340-30-25-2 and is therefore capitalized in accordance with ASC 340-40-25-1. Entity A concludes that the asset is related to the entire contract to provide 13 months of marketing services.</td>
</tr>
</tbody>
</table>

In this fact pattern, the entity cannot elect the practical expedient in ASC 340-40-25-4 to expense costs as incurred since the amortization period of the asset that the entity would otherwise recognize is more than one year (i.e., the 13 months in which marketing services are being performed).

13.2.4 Using the Portfolio Approach When Accounting 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.”

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, it 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).

### 13.2.5 Determining When to Recognize and How to Measure Incremental Costs

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.

The new revenue standard does not address the issue of when to initially recognize the incremental costs of obtaining a contract. Rather, ASC 340-40 only addresses which costs to capitalize and subsequent recognition of amortization or impairment expense. Therefore, 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 above issue is addressed in Implementation Q&A 78 (compiled from previously issued TRG Agenda Papers 57 and 60). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.
Chapter 13 — Contract Costs

13.3 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.

**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 flowchart below illustrates the process that entities should use in applying the guidance in ASC 340-40-25-5 through 25-8 to determine how to account for costs of fulfilling a contract with a customer.

- **Are costs to fulfill a contract in the scope of other accounting standards?**
  - Yes: Account for costs in accordance with the other standards.
  - No: **Do the costs relate directly to a contract or specific anticipated contract?**
    - Yes: **Do the costs generate or enhance resources that will be used in satisfying performance obligations in the future?**
      - Yes: Expense costs as incurred.
      - No: **Are the costs expected to be recovered?**
        - Yes: Recognize fulfillment costs as an asset.
        - No: Expense costs as incurred.
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. In addition, 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. Further, when determining whether fulfillment costs are within the scope of ASC 340-40, the reporting entity should also consider its relationship with the other entity in the arrangement. That is, if the reporting entity incurs costs and transfers consideration to another entity, and that other entity also transfers consideration to the reporting entity in exchange for goods or services, the reporting entity should consider whether the consideration exchanged between the two parties should be accounted for as (1) consideration payable to a customer under ASC 606 or (2) consideration received from a vendor under ASC 705-20. For additional discussion, see Sections 3.2.8 and 6.6.2.5.

The boards’ intent in developing this guidance was to develop a clear objective for recognizing and measuring an asset arising from the costs incurred 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.

**Connecting the Dots — 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 Section 13.3.4); 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 R&D 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.
Example 2 in ASC 340-40 illustrates how to account for costs of fulfilling a contract:

**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.

**Costs to Fulfill a Contract**

55-7 The initial costs incurred to set up the technology platform are as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design services</td>
<td>$40,000</td>
</tr>
<tr>
<td>Hardware</td>
<td>$120,000</td>
</tr>
<tr>
<td>Software</td>
<td>$90,000</td>
</tr>
<tr>
<td>Migration and testing of data center</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Total costs</strong></td>
<td><strong>$350,000</strong></td>
</tr>
</tbody>
</table>

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.

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.

### 13.3.1 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 13.4.2). Determining whether capitalized costs are recoverable may be challenging when the contract contains variable consideration rather than fixed consideration.

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.
An entity should not defer costs associated with transferred goods or services in a contract when variable consideration is fully or partially constrained. Rather, 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 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 13-9**

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.\(^2\) As a result, A incurs a loss of $10,000.

### 13.3.2 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 Example 13-10 below.

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\(^1\) 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.

\(^2\) The entity may need to consider applying the impairment guidance in ASC 330 to similar goods held in inventory.
Example 13-10

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 require 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.

When the equipment is sold for $150, E is not 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.

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.

Connecting the Dots — Expected Profit on Optional Future Purchases

In November 2015, 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 Chapter 11.

The above issue is addressed in TRG Agenda Paper 49. For additional information and Deloitte's summary of issues discussed in the TRG Agenda Papers and Implementation Q&As, see Appendix C.

13.3.3 Contracts Satisfied Over Time

ASC 340-40-25-8(c) requires fulfillment costs attributed to satisfied (or partially satisfied) performance obligations to be expensed as incurred. Although legacy U.S. GAAP might allow for revenue and cost of revenue to be accounted for concurrently (resulting in a consistent profit margin), 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.
13.3.3.1 Recognition of Fulfillment Costs Incurred Before the Transfer of Goods or Services When Revenue Is Recognized Over Time

ASC 340-40-25-5 requires an entity to capitalize the costs incurred to fulfill a contract with a customer if the 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 . . .

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. [Emphasis added]

ASC 340-40-25-7 provides various examples of contract fulfillment costs, including direct labor, direct materials, and allocations of costs that are directly related to the contract (e.g., insurance, depreciation of tools and equipment used). In some contracts, fulfillment costs (e.g., implementation or other set-up costs) may be incurred before an entity begins satisfying its performance obligation. Further, in some cases, the costs incurred will enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer.

An entity may need to exercise significant professional judgment when determining whether fulfillment costs incurred enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer. To evaluate whether fulfillment costs meet the criterion in ASC 340-40-25-5(b) for capitalization, an entity should consider whether the costs (1) generate or enhance a resource (i.e., an asset, including a service) that will be transferred to the customer or (2) will be used by the entity in connection with transferring goods or services to the customer. The following considerations may be helpful in the evaluation:

• Is the customer's ability to benefit from the fulfillment activities limited to the use of the entity's service? If the customer cannot benefit from the entity's fulfillment activities other than from the use of the entity's service, the fulfillment costs may be enhancing the entity's resources.

• Do the fulfillment activities expand the entity's service capabilities? If the fulfillment activities are required before the entity can begin transferring services to the customer and they expand the entity's service capacity, the related fulfillment costs would most likely enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer.

We do not believe that an entity needs to have physical custody of an enhanced resource for fulfillment costs to qualify for capitalization under ASC 340-40-25-5(b). For example, the criterion in ASC 340-40-25-5(b) could be met if the enhancements are made at the customer's location but will be used by the entity in connection with satisfying the performance obligation(s).

If the costs generate or enhance a resource that will be transferred to the customer, they may not enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer. Such costs may still initially meet the criteria for capitalization (under either ASC 340-40 or other U.S. GAAP), but such costs would typically be recognized as an expense once the related asset is transferred to the customer.
Example 13-11

Pepper Inc. enters into a four-year contract with a customer to provide hosted software services. Before the hosted software services can begin, Pepper Inc. is required to perform implementation services, which create interfaces between the customer's infrastructure and Pepper Inc.'s hosted software. The implementation services will not transfer to the customer a good or service that is distinct because the customer can only benefit from the interface connection through use of the hosted software services. For the implementation services, Pepper Inc. charges the customer $600, which is included in the overall transaction price that is allocated to the performance obligation to provide hosted software services. Pepper Inc. incurs fulfillment costs of $500 to perform the implementation services.

Because the implementation services do not transfer a distinct good or service to the customer, the fulfillment costs of $500 do not enhance a resource that will be controlled by the customer. Rather, the fulfillment costs enhance a resource that Pepper Inc. will use to satisfy its performance obligation. Therefore, the fulfillment costs of $500 meet the criterion in ASC 340-40-25-5(b) for capitalization.

13.3.3.2 Fulfillment Costs Related to Past Performance When Revenue Is Recognized Over Time

Example 13-12 below illustrates the accounting for costs related to performance completed to date that an entity incurred to fulfill a contract satisfied over time.

Example 13-12

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.

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.
13.3.3.3 Accounting for Costs Incurred in the Production of a Customized Good

Sometimes, an entity may incur costs at or near contract inception but before it begins to satisfy its performance obligations under the contract. This situation can arise when an entity purchases raw materials that will be used in the production of a customized good, as illustrated in Example 13-13 below.

Example 13-13

Company KB produces aluminum-related products (“widgets”), which are created through a process of melting, molding, and curing the aluminum into a unique customized widget. The cost of the raw materials (i.e., aluminum) is significant to the overall cost of a widget (approximately 40–60 percent of the overall cost of the finished good). To produce a widget, KB must perform the following activities:

- Procure the aluminum (i.e., the raw materials).
- Melt the aluminum.
- Mold the aluminum.
- Polish the molded aluminum (i.e., polish the widget).

The raw materials (i.e., aluminum) purchased by KB are standard and not unique to a specific customer (i.e., KB can use the raw materials to fulfill any customer order). The molding’s design is based on a customer’s specifications (i.e., the mold used to create the widget is unique to a specific customer). Because the raw materials are not unique to a specific customer, KB could redirect the raw materials (and the melted aluminum) to a different customer before pouring the melted aluminum into the molding. However, once KB pours the melted aluminum into the mold, KB would incur significant costs to rework the molded aluminum for another customer. Therefore, the aluminum has no alternative use to KB other than to fulfill the initial order placed by a specific customer.

In addition, the termination clauses in KB’s contracts provide KB with an enforceable right to payment for performance completed to date if the contract is canceled. Accordingly, KB concludes that its performance obligation to produce a customized widget meets the criterion in ASC 606-10-25-27(c) to be satisfied over time because the completed widget has no alternative use and KB has an enforceable right to payment for performance completed to date. Company KB determines that the most appropriate measure of progress for recognizing revenue over time is labor hours incurred (that conclusion is not the subject of this example).

On March 26, 20X8, KB enters into a contract with a customer to produce a customized widget for a fixed price of $120. In a manner consistent with its general revenue recognition policy, KB recognizes revenue related to its contract over time by using labor hours incurred as the measure of progress.

Company KB expects that it will incur the following labor hours to produce the customized widget:

<table>
<thead>
<tr>
<th>Description</th>
<th>Hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor to pour the aluminum into the molding</td>
<td>2</td>
</tr>
<tr>
<td>Labor to extract the aluminum in the form of a widget from the molding</td>
<td>78</td>
</tr>
<tr>
<td>Labor to polish the widget after taking it out of the molding</td>
<td>20</td>
</tr>
<tr>
<td>Total hours</td>
<td>100</td>
</tr>
</tbody>
</table>
Example 13-13 (continued)

As noted above, before KB pours the melted aluminum into the molding, the aluminum has an alternative use to KB (i.e., KB can redirect the aluminum to another customer regardless of whether the aluminum is solid or liquid). Accordingly, until the aluminum is poured into the customer-specific molding, KB recognizes the aluminum in its raw material inventory. It is only when the melted aluminum is poured into the molding that KB will begin to perform under its contract with the customer because this is the point in time at which the aluminum has no alternative use to KB (i.e., because KB would incur significant costs to rework the molded aluminum for another customer). Therefore, KB should begin to recognize revenue once it pours the melted aluminum into the molding. On the basis of labor hours incurred, KB concludes that satisfaction of its performance obligation will be 2 percent complete once it begins to perform under the contract (i.e., when it begins pouring the melted aluminum into the molding). Consequently, KB will recognize revenue of $2.40 (2 percent of the fixed price per widget of $120) once the aluminum is melted and KB begins to pour the aluminum into the molding.

As also noted above, the cost of the raw materials (i.e., aluminum) is significant to the overall cost of the widget. In this arrangement, KB pays $50 for the aluminum materials. Company KB expects that its total cost of fulfilling the contract (inclusive of the $50 raw material cost) will be $100. That is, the raw material cost represents 50 percent of the estimated total costs that KB will incur under the contract.

Company KB should expense the cost of the aluminum once the melted aluminum is poured into the molding because this is the point in time at which the aluminum no longer has an alternative use to KB, which indicates that KB has commenced its performance under the contract (i.e., satisfaction of its performance obligation is 2 percent complete). Accordingly, the cost of the aluminum, which represents a fulfillment cost under the contract, should be expensed. This conclusion is consistent with the guidance in ASC 340-40-25-8(c), which requires costs related to satisfied or partially satisfied performance obligations to be expensed as incurred.

In addition to being consistent with the guidance in ASC 340-40-25-8(c), the conclusion in Example 13-13 that the cost of the aluminum should be expensed once the aluminum no longer has an alternative use to the entity is consistent with the following view expressed by the FASB staff in Implementation Q&A 76 (compiled from previously issued TRG Agenda Papers 33 and 34) regarding an analogous fact pattern:

The staff's view is that costs incurred before the [contract establishment date (CED)] are costs to fulfill an anticipated contract and would be recognized as an asset under the guidance in Subtopic 340-40. Costs would be expensed immediately at the CED if they relate 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 over which the goods or services to which the asset relates will be transferred to the customer.

13.3.3.4 Costs Incurred to Fulfill a Combined Performance Obligation Satisfied Over Time

ASC 340-40-25-5 through 25-8 provide guidance on accounting for costs incurred to fulfill a contract with a customer within the scope of ASC 606. Specifically, ASC 340-40-25-5 requires the following three criteria to be met for an entity to capitalize costs incurred to fulfill such a contract:

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify . . .

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.
In addition, ASC 340-40-25-8 requires an entity to 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).

As quoted above, ASC 340-40-25-8(c) indicates that an entity should not capitalize costs related to completely or partially satisfied performance obligations. Further, ASC 340-40-25-8(d) requires an entity to expense costs when incurred if the entity cannot determine whether the costs are related to past performance or to future performance. Accordingly, if an entity incurs costs related to past performance or cannot determine whether the costs are related to past performance or to future performance, the entity should expense the costs when incurred rather than capitalize them.

In some arrangements, costs (other than set-up costs) are incurred at or around the time an entity begins to satisfy a performance obligation. For example, an entity may physically deliver hardware used as part of a combined performance obligation to provide services (e.g., an integrated monitoring solution) to a customer over time. That is, the hardware is not distinct; rather, it forms part of a combined performance obligation that is satisfied over time. The hardware may be recorded by the entity as inventory before it is physically transferred to the customer and would typically be derecognized by the entity once it is physically delivered to the customer since it would most likely be a fulfillment cost.

Depending on the facts and circumstances, it may or may not be acceptable under ASC 340-40 for an entity to capitalize initial fulfillment costs incurred when the costs are related to part of a combined performance obligation that will be satisfied over time. Generally, before delivery, the asset to which the fulfillment costs are related (e.g., hardware) is held in the entity's inventory and is therefore within the scope of the inventory accounting guidance of ASC 330. However, once the asset is physically transferred to the customer, the asset may no longer be within the scope of ASC 330.

We observe that when the guidance in ASC 330 is applicable, ASC 330-10-10-1 and ASC 330-10-35-2 are particularly relevant to the determination of when to recognize the cost (i.e., expense) of the asset. ASC 330-10-10-1 states:

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

ASC 330-10-35-2 states, in part:

The cost basis of recording inventory ordinarily achieves the objective of a proper matching of costs and revenues.

Because the cost should be recognized with the related revenue, we believe that it may sometimes be acceptable to defer the cost.
In addition, we believe that in some cases, the asset may no longer be within the scope of ASC 330 once it is deployed in a specific customer contract (i.e., once it is shipped to a customer). At this point, the costs related to the asset could be evaluated as contract fulfillment costs in accordance with ASC 340-40.

If ASC 340-40 is applicable, an entity should consider the three criteria in ASC 340-40-25-5 to determine whether capitalization of the costs is appropriate. Generally, the asset to which the costs are related is physically delivered to the customer as part of a specific contract with that customer; therefore, criterion (a) is met. Further, if the entity expects to recover the costs of the delivered asset through the transaction price, the entity would conclude that criterion (c) is met.

Unlike the evaluations of criteria (a) and (c), respectively, which are relatively straightforward, the evaluation of whether criterion (b) is met (i.e., whether the costs generate or enhance a resource of the entity that the entity will use to satisfy its performance obligation in the future) generally requires more judgment. As discussed in Section 13.3.3.1, an entity should consider the following factors to determine whether the asset delivered to the customer generates or enhances a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer:

- Is the customer’s ability to benefit from the fulfillment activities limited to the use of the entity’s service? If the customer cannot benefit from the entity’s fulfillment activities other than from the use of the entity’s service, the fulfillment costs may be enhancing the entity’s resources.
- Do the fulfillment activities expand the entity’s service capabilities? If the fulfillment activities are required before the entity can begin transferring services to the customer and they expand the entity’s service capacity, the related fulfillment costs would most likely enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer.

We also believe that the following additional factors are relevant to the determination of whether capitalization of the fulfillment costs is appropriate:

- Does the activity that results in delivery of the asset to the customer factor into the entity’s measure of progress toward complete satisfaction of the performance obligation? For example, the entity may demonstrate that the fulfillment costs enhance a resource that will be used to satisfy the entity’s performance obligation in the future if the entity does not begin satisfying its performance obligation until the asset is delivered to the customer.
- Does the entity still have some level of control or influence over the asset once the asset is physically delivered to the customer? Although the asset is physically delivered to the customer, the entity may be providing a service that requires the entity to integrate the asset and the service to deliver a combined output (e.g., because the asset and service are highly interdependent or highly interrelated). The entity may conclude that by transferring a combined service to the customer (e.g., a service that the entity delivers by using both hardware and the service), it continues to maintain some level of control or influence over the asset that is being used as an input to deliver a combined output. That is, the entity’s service continues to dictate how the customer uses the asset even if the customer has physical possession. This analysis is consistent with the evaluation of whether an entity controls a good or service before the good or service is transferred to an end customer and therefore is a principal, as discussed in ASC 606-10-55-37A(c).
On the basis of the above factors, an entity should evaluate whether the fulfillment costs enhance the entity's resources that the entity will use to satisfy (or continue to satisfy) its performance obligation in the future. If the entity determines that capitalization of the related costs is appropriate in accordance with ASC 340-40-25-5, it should subsequently amortize the costs related to the asset as it transfers the related services.

Because of the level of judgment necessary to evaluate whether capitalization is appropriate — specifically, whether the asset generates or enhances a resource of the entity that the entity will use to satisfy its remaining performance obligation — we would encourage entities with similar types of arrangements to consult with their accounting advisers. Further, it may be appropriate in some cases to evaluate whether the arrangement contains a lease when the performance of the contract relies on a specified asset; see Deloitte’s A Roadmap to Applying the New Leasing Standard for more information on determining whether a contract is or contains a lease.

13.3.3.5 Learning Curve Costs

Certain contracts may include significant costs associated with a “learning curve.” In these instances, because the entity has not yet gained process and knowledge efficiencies, significant costs attributed to a learning curve may be incurred during the early phases of the contract.

We believe that learning curve costs are generally not eligible for capitalization under ASC 340-40. This view is consistent with paragraphs BC312 through BC314 of ASU 2014-09, in which the FASB states, in part, that ASC 606 addresses the accounting for the effects of learning costs when both of the following conditions are met:

- “An entity has a single performance obligation to deliver a specified number of units.”
- “The performance obligation is satisfied over time.”

The FASB states that in this situation, an entity would most likely select the cost-to-cost method to measure the progress of transferring the goods or services to the customer since under this method, the entity would record more revenue and expense for the units produced early in the production cycle (as a result of the learning curve costs) than it would for the later units. The Board explains that this method of measurement is appropriate because if an entity were to sell a customer only one unit rather than multiple units, the entity would charge the customer a higher per-unit price to recover its learning curve costs. Since the performance obligation is satisfied over time (because control is transferred to the customer as the costs are incurred), capitalization of learning curve costs would not be appropriate in this situation because the costs are related to the fulfillment of a partially satisfied performance obligation.

13.3.3.6 Labor Costs Incurred to Fulfill a Contract for Goods or Services When Revenue Is Recognized Over Time

ASC 340-40-25-7 provides guidance on the types of costs that constitute fulfillment costs within the scope of ASC 340-40 if they are outside the scope of other Codification topics. Costs incurred to produce goods for which revenue is recognized at a point in time would typically be treated as inventory costs within the scope of ASC 330. However, costs incurred to provide goods or services for which revenue is recognized over time would typically not be within the scope of ASC 330 since control over those goods or services is transferred to the customer as the entity performs.

Questions have arisen regarding the amounts to be included in fulfillment costs related to labor.
While “salaries and wages of employees who provide the promised services directly to the customer” are the only example of direct labor costs that is cited in ASC 340-40-25-7(a), direct labor costs also include fringe benefits and other labor-related costs incurred in compensating an employee whose primary employment efforts are directly related to a contract with a customer. In addition, ASC 340-40-25-7(c) indicates that fulfillment costs include certain allocated labor costs (i.e., indirect labor costs) related to overhead, such as those incurred for contract management and supervision.

We believe that costs that would have been capitalizable as inventory had they been within the scope of ASC 330 would typically also represent fulfillment costs directly related to a contract in accordance with ASC 340-40. ASC 330-10-30-1 provides the following guidance on determining the amounts to be included in inventory:

> As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost, and its determination involves many considerations.

In authoritative literature, specific references to the composition of labor costs are limited. However, the ASC master glossary's definition of direct loan origination costs includes a reference to ASC 310-20-55, which includes examples of forms of employee compensation that would be considered direct labor costs associated with originating a loan. Although the concepts discussed in the examples are specifically related to direct costs incurred in connection with loan origination activities, we believe that it is appropriate for an entity to consider the implementation guidance in ASC 310-20 by analogy to identify forms of employee compensation that should be included in the composition of labor costs.

The example in ASC 310-20-55-12 states:

> Payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:
> a. Payroll taxes
> b. Dental and medical insurance
> c. Group life insurance
> d. Retirement plans
> e. 401(k) plans
> f. Stock compensation plans, such as stock options and stock appreciation rights
> g. Overtime meal allowances.

Further, ASC 310-20-25-6 states, in part:

> Bonuses are part of an employee's total compensation. The portion of the employee's total compensation that may be deferred as direct loan origination costs is the portion that is directly related to time spent on the activities contemplated in the definition of that term and results in the origination of a loan.

We believe that in a manner consistent with the above guidance, labor costs include base pay, overtime pay, vacation and holiday pay, illness pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan. Further, other employee benefit costs such as cash bonuses, profit sharing, stock bonus plans, insurance benefits, retirement benefits, and other miscellaneous benefits (both discretionary and nondiscretionary) are among the labor costs that are eligible for inclusion in fulfillment costs directly related to a contract.
13.3.4 Costs Related to Preproduction Activities

Preproduction costs of a long-term supply arrangement represent incurred costs related to the design and development of products to be sold under an entity’s contract with a customer, which could be an anticipated contract that the entity can specifically identify. For example, preproduction costs could include dies and other tools (tooling) that the entity will use in making products under the arrangement. The dies and other tools may or may not be transferred to the customer under such an arrangement.

The TRG addressed certain issues related to the costs that an entity incurs in performing these 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). Specifically, TRG members in the United States discussed whether entities should continue to account for certain preproduction costs under ASC 340-10 or whether such costs will be within the scope of ASC 340-40 after the new revenue standard becomes effective.

The FASB considered removing the guidance in ASC 340-10 to confirm that these costs would be within the scope of ASC 340-40. However, in February 2017, the FASB ultimately elected to retain the guidance in ASC 340-10 on accounting for preproduction costs related to long-term supply arrangements. Accordingly, the costs previously within the scope of ASC 340-10 will continue to be within the scope of ASC 340-10.

The above issue is addressed in Implementation Q&A 66 (compiled from previously issued TRG Agenda Papers 46 and 49). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

While retaining the guidance in ASC 340-10 will clarify how to account for costs that are squarely within the scope of that guidance, there remain implementation issues related to the accounting for fulfillment costs that are not clearly within the scope of ASC 340-10 (or other applicable U.S. GAAP) and to which the guidance in ASC 340-40 may be applicable. For example, when an entity begins incurring costs that enhance a resource that may be used to satisfy an obligation with a potential customer (i.e., there is not yet a contract with a customer), or when an entity receives consideration from a potential customer to fully or partially cover the costs incurred, the entity may need to use significant judgment in determining whether the fulfillment costs incurred are within the scope of ASC 340-40. We believe that entities may find the following considerations helpful when evaluating the accounting for preproduction costs:

- Are the fulfillment costs related to a contract with a customer that can be specifically identified? If so, the costs are likely to be within the scope of ASC 340-40 (if they are not within the scope of other guidance).

- Do the fulfillment costs create a good or service that will be transferred to a customer? If so, the costs are likely to be deferred until the good or service is transferred to the customer.

- Do the fulfillment costs create an output that is part of the entity’s ordinary activities? If the costs incurred create an asset that will be transferred to a third party, but the asset to be transferred is not an output of the entity’s ordinary activities, the counterparty is not a customer as defined in ASC 606, and therefore, the arrangement is not within the scope of ASC 606 or ASC 340-40.
Entities may receive payments from customers, potential customers, or third parties that are intended to cover some or all of the costs of certain preproduction activities. An entity's conclusion regarding the scope of the associated costs may inform the entity's accounting for the corresponding payment. For example, if an entity concludes that it is incurring preproduction costs that are within the scope of ASC 340-40 but are not related to a good or service that will be transferred to the customer (i.e., the costs are not performance obligations), any consideration that the entity received from the customer would be within the scope of ASC 606 and would form part of the transaction price in the contract with the customer. However, if an entity concludes that the fulfillment costs incurred are not within the scope of ASC 340-40 (e.g., because they are not related to a contract or anticipated contract that the entity can specifically identify), third-party reimbursements of such costs may not be within the scope of ASC 606.

Further, we are also aware that there may be instances under legacy U.S. GAAP in which an entity is not squarely within the scope of ASC 340-10 (e.g., the entity does not enter into long-term supply arrangements), but the entity applies the guidance by analogy. Upon transition to the new revenue standard, entities that have analogized to ASC 340-10 under legacy U.S. GAAP should reconsider whether application of ASC 340-10 by analogy is appropriate or whether they would be within the scope of ASC 340-40. As discussed in Section 3.2.7, for an arrangement to be within the scope of ASC 340-40, it must first be within the scope of ASC 606.

13.3.5 Set-Up and Mobilization Costs

Set-up and mobilization costs represent certain direct costs incurred at contract inception to allow an entity to satisfy its performance obligations. For example, when construction companies prepare to begin performance under a contract with a customer, they often incur direct costs related to the transportation (i.e., “mobilization”) of equipment (e.g., cranes, cement trucks) that they would not have incurred if the contract had not been obtained. Frequently, these costs do not result in the transfer of a good or service to the customer; rather, they represent set-up activities. The costs incurred in the mobilization of such machinery (e.g., labor, overhead, other direct costs) may meet the definition of assets under other U.S. GAAP, such as the guidance on property, plant, and equipment. To the extent that costs are not within the scope of other accounting standards and do not result in the transfer of a good or service to the customer, entities should assess these costs in accordance with the new revenue standard’s cost guidance in ASC 340-40.

If an entity has acquired new equipment to be used in the fulfillment of a contract, certain costs that the entity incurred in transporting the new equipment to a designated location must be capitalized as an asset under ASC 360. In contrast, once equipment has been used and is then transported for use under a separate contract, such costs would no longer be within the scope of ASC 360. However, the costs may be viewed as fulfillment costs. If the entity concludes that the costs are fulfillment costs outside the scope of ASC 360, it should apply the guidance in ASC 340-40 to determine whether capitalization is appropriate.
Example 13-14 below illustrates the accounting for set-up and mobilization costs.

**Example 13-14**

Company A enters into a contract with a customer to construct an urban skyscraper over a two-year period. To fulfill the contract, A determines that it will need to purchase two new cranes. Company A incurs $150,000 to have these cranes transported to a facility where A stores cranes that are not currently deployed. The company also incurs $500,000 in direct costs to transport the two new cranes and five additional cranes from the storage area to the designated customer location. Company A determines that the transportation costs are expected to be recovered through the contract with the customer. In addition, A concludes that the use of the cranes to construct the skyscraper does not constitute a lease under ASC 840 (or under ASC 842, if A has adopted the new leasing standard).

Because the $150,000 represents costs incurred to get new equipment ready for its intended use (i.e., transportation of newly acquired equipment), A should apply the guidance in ASC 360 to account for such costs.

Regarding the $500,000 in direct costs to transport the cranes to the customer's location: ASC 340-40-25-5 requires an entity to recognize an asset for costs incurred in the fulfillment of a contract if the costs (1) are directly related to the contract, (2) enhance the resources that the entity will use to perform under the contract, and (3) are expected to be recovered. Company A should recognize the transportation costs of $500,000 as an asset when incurred because (1) the cranes (and therefore the related transportation costs) are directly related to the contract, (2) relocating the cranes enhances the entity's resources (i.e., the cranes) since it puts the cranes in a location that allows the entity to satisfy its performance obligation(s) under the contract, and (3) A has determined that the transportation costs are expected to be recovered.

### 13.4 Amortization and Impairment of Contract Costs

#### 13.4.1 Amortization

ASC 340-40 does not provide specific guidance on the method an entity should use to amortize contract costs recognized as assets. Rather, ASC 340-40-35-1 requires an entity to amortize such costs “on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.” 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.

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 is expected to renew that contract for two years, the appropriate amortization period may be six years (i.e., the expected duration of the period in which the customer will purchase the related goods or services, which could be the expected life of the customer 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.

### 13.4.1.1 Allocation Among Performance Obligations

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. For example, the costs could be allocated on the basis of the stand-alone selling prices of the performance obligations.

The FASB staff has noted that an entity could satisfy the requirement in ASC 340-40-35-1 in accordance with either of the following two views:³

(a) View A — Allocate the asset to the individual performance obligations on a relative basis (in proportion to the transaction price allocated to each performance obligation) and amortize the respective portion of the asset based on the pattern of performance for the underlying performance obligation. . . .

(b) View B — Amortize the single asset using one measure of performance considering all of the performance obligations in the contract. Use a measure that best reflects the “use” of the asset as the goods and services are transferred. Note that this approach may result in a similar pattern of amortization as View A, but without any specific allocation of the contract cost asset to individual performance obligations.

³ Quoted text from Implementation Q&A 75.
Note that as discussed in Section 13.2.3.2, 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 so 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.

The above issue is addressed in Implementation Q&A 75 (compiled from previously issued TRG Agenda Papers 23 and 25). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

Example 13-15 below illustrates an allocation of the costs of obtaining a contract among different performance obligations.

**Example 13-15**

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 is therefore capitalized in accordance with ASC 340-40-25-1.

As discussed above, 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. Therefore, it would be acceptable 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:

<table>
<thead>
<tr>
<th></th>
<th>Delivery (Day 1)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product X</td>
<td>$ 120</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance</td>
<td>—</td>
<td>$ 40</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extended warranty</td>
<td>—</td>
<td></td>
<td>$ 20</td>
<td>$ 20</td>
</tr>
<tr>
<td>Total amortization expense</td>
<td>$ 120</td>
<td>$ 40</td>
<td>$ 20</td>
<td>$ 20</td>
</tr>
</tbody>
</table>
Example 13-15 (continued)

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 (see Section 13.2.3.3). 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 Section 13.2.3.2).

13.4.1.2 Determining the Amortization Period of an Asset Recognized for the Incremental Costs of Obtaining a Contract With a Customer

Stakeholders have raised questions about determining the amortization period of an asset recognized for the incurred incremental costs of obtaining a contract with a customer, including how to determine whether a commission paid on renewal is commensurate with an initial commission and under what circumstances it would be appropriate to amortize the asset over the expected customer life. The FASB staff has noted that the amortization guidance in ASC 340-40 is conceptually consistent with that on estimating the useful lives of long-lived assets. Since entities already use judgment to estimate useful lives of long-lived assets, the staff believes that entities would also do so in determining amortization periods for assets related to incremental costs of obtaining a contract.

An entity should use judgment in determining the contract(s) to which a commission is related. The staff has noted that if an entity pays a commission on the basis of only the initial contract without an expectation that the contract will be renewed (given the entity's past experience or other relevant information), amortizing the asset over the initial contract term would be an appropriate application of the new revenue standard. However, if the entity's past experience indicates that a contract renewal is likely, the amortization period could be longer than the initial contract term if the asset is related to goods or services to be provided during the contract renewal term.

When estimating the amortization period of an asset arising from incremental costs of obtaining a contract, entities should (1) identify the contract(s) to which the cost (i.e., commission) is related, (2) determine whether the commission on a renewal contract is commensurate with the commission on the initial contract, and (3) evaluate the facts and circumstances to determine an appropriate amortization period that would extend beyond the contract period if there are anticipated renewals associated with the costs of obtaining the contract.

The FASB staff has confirmed that the amortization period of an asset recognized for the incremental incurred costs of obtaining a contract might be, but should not be presumed to be, the entire customer life. The staff has suggested that facts and circumstances may clearly indicate that amortizing the asset over the average customer term is inconsistent with the amortization guidance in ASC 340-40-35-1. An entity should use judgment in assessing the goods or services to which the asset is related.

In estimating the amortization period for an asset recognized in accordance with ASC 340-40-25-1 ("customer acquisition asset"), an entity will need to use judgment to identify "the goods or services to which the asset relates." The estimated amortization period could range from the initial contract term on the low end to the average customer life on the high end depending on the specific facts and circumstances. When determining the life of the customer acquisition asset, the entity will need to make judgments similar to those it makes when determining the amortization or depreciation period for other long-lived assets.
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An entity should first identify the contract(s) related to the customer acquisition asset (e.g., commission payment). That is, an entity will need to consider whether the asset is related only to the initial contract with the customer or also to specific anticipated contracts (e.g., renewals) with the customer. For example, if a commission is paid on contract renewals and the commission is commensurate with the initial commission paid, the customer acquisition asset originally recorded may be related only to the initial contract.

However, if an entity’s past experience indicates that a contract renewal is likely, the amortization period could be longer than the initial contract term if the asset is related to goods or services to be provided under a contract renewal. An entity will need to use judgment to determine whether the asset is related to goods or services to be provided under the contract renewal term. Amortizing an asset over a period longer than the initial contract period would not be appropriate when the entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract.

If no commissions are incurred in connection with a contract renewal, or if the commission paid is not commensurate with the initial commission, an entity will need to use judgment when determining whether the customer acquisition asset is related to (1) all future contracts with the customer (i.e., the customer life) or (2) one or more, but not all, future contracts with the customer. The new revenue standard does not require an entity to amortize a customer acquisition asset over the expected customer life. Rather, the asset should “be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or service to which the asset relates.” An entity will need to determine the appropriate amortization period on the basis of all relevant facts and circumstances.

Since the capitalized asset is similar to an intangible asset, an entity might consider the guidance in ASC 350-30 on determining the useful life of intangible assets. Specifically, ASC 350-30-35-3 states, in part:

The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular, all of the following factors with no one factor being more presumptive than the other: . . .

f. The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

Entities may perform various activities geared toward maintaining customer relationships. In some instances, there may be significant barriers to a customer’s changing service providers or suppliers so that once a contractual relationship is formed between an entity and a customer, little effort may be needed for the entity to retain the customer. However, in other circumstances, entities may operate in a highly competitive environment in which there are only limited barriers, if any, to a customer’s switching service providers or suppliers. In these circumstances, entities may need to make additional investments or incur other costs to maintain customer relationships (e.g., invest in innovative products or services, or provide customer incentives). The additional investments may be akin to “maintenance expenditures” that may affect the useful life of a customer acquisition asset.
While an entity will need to use judgment to determine the amortization period of the customer acquisition asset, the entity might consider the following factors:

- **Incremental costs of obtaining a sale (e.g., commissions) relative to ongoing contract value** — A small commission relative to the value of the contract could suggest that the customer acquisition asset has limited value and that the asset life is relatively short. In contrast, a higher commission payment relative to the contract value (1) could suggest that the entity believes the asset to be of greater value or (2) may be related to anticipated contracts with the customer.

- **Degree of difficulty in switching service providers or suppliers** — If it is difficult for a customer to switch service providers or suppliers, the customer acquisition asset may have a longer life. Accordingly, the entity may expect that the efforts it performed to acquire the customer will provide it with value over a longer period (i.e., over some or all contract renewals). In contrast, if there are only limited barriers to a customer's switching service providers or suppliers (and there are other service providers or suppliers available to the customer), the customer acquisition asset may have a shorter life.

- **Extent to which the product or service changes over the customer life** — Significant changes in the underlying product or service over the customer life may suggest that the life of the customer acquisition asset is shorter than the customer life. That is, the asset may be related to some, but not all, anticipated contracts with the customer. For example, if a customer's decision about whether to renew a contract is influenced by enhancements made to products or services, the activities required to initially obtain the customer may not be related to all anticipated contract renewals with the customer. In contrast, if the same service or product is provided in each renewal period, the customer acquisition asset may be attributed to all anticipated contract renewals.

- **Other customer maintenance activities** — If the entity incurs significant costs (relative to the initial incremental cost incurred) to maintain a customer relationship, the useful life of the customer acquisition asset could be short. However, if only limited costs are required to maintain a customer relationship, the useful life of the customer acquisition asset could extend to all anticipated contracts with the customer (i.e., the customer life). Fulfillment costs would not be considered customer maintenance costs. Only costs that are incremental to transferring the specified goods or services to the customer should be evaluated as maintenance costs.

The above factors are not all-inclusive, and none of them are determinative. Accordingly, an entity should consider all relevant facts and circumstances when determining the amortization period for customer acquisition assets. In addition, an entity should adequately disclose the method it uses to determine the amortization for each reporting period in accordance with ASC 340-40-50-2(b).

The above issue is addressed in Implementation Q&As 71 and 79 (compiled from previously issued TRG Agenda Papers 23, 25, 57, and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

### 13.4.1.2.1 Specific Anticipated Contract Not Limited to Contract Renewals

The reference to a “specific anticipated contract” in ASC 340-40-35-1 is not limited to contract renewals. Although the guidance in ASC 340-40-35-1 will often be relevant in the context of contract renewals (see Section 13.4.1.2), it is not limited to contract renewals for purposes of determining the amortization period for capitalized incremental costs incurred to obtain a contract.
For example, an entity may incur incremental costs of obtaining a contract to deliver one part of an overall project for a customer. The entity may have been informed that if it successfully fulfills its performance obligations under the initial contract, the customer will award the entity an additional contract to deliver other parts of the project. If the entity will not incur any further incremental costs to obtain the additional contract, it may be appropriate to regard the additional contract as a “specific anticipated contract” under ASC 340-40-35-1.

13.4.1.2.2 Evaluating Whether Commissions Paid on a Contract Renewal Are Commensurate With Commissions Paid on the Initial Contract

Paragraph BC309 of ASU 2014-09 states that amortization of an asset over a period longer than the initial contract period would not be appropriate when a commission paid on a contract renewal is commensurate with the commission paid on the initial contract.

The FASB staff has confirmed that when commissions are paid on contract renewals, an entity should evaluate whether the commission on renewal is commensurate with the initial commission by considering the amount of the commissions relative to the contracts’ value. It has specifically noted that “assessing whether a renewal commission is commensurate with an initial commission solely on the basis of the level of effort to obtain the contract would not be consistent with the guidance in Subtopic 340-40.”

In addition, the FASB staff has clarified that it holds the following views irrespective of the relative level of effort involved with obtaining the original contract and the renewal contract:

- “[I]n general, it would be reasonable for an entity to conclude that a renewal commission is ‘commensurate with’ an initial commission if the two commissions are reasonably proportional to the respective contract value (for example, 5% of the contract value is paid for both the initial and the renewal contract).”
- “Similarly, [it] would be reasonable for an entity to conclude that a renewal commission is not ‘commensurate with’ an initial commission if it is disproportionate to the initial commission (for example, 2% renewal commission as compared to a 6% initial contract commission).”

The above issue is addressed in Implementation Q&A 72 (compiled from previously issued TRG Agenda Papers 23, 25, 57, and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

13.4.1.2.3 Determining the Appropriate Amortization Period of Commissions When a Commission Paid Upon Renewal Is Not Commensurate With the Initial Commission

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? The amortization period will depend on many factors, including whether a commission is paid on contract renewals and, if so, whether the commission paid is commensurate with the initial commission.

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4 Quoted from Implementation Q&A 72.
5 See footnote 4.
Example 13-16

Entity X enters into a two-year contract with a customer. On signing the initial contract, X 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, 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 X’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 approaches to amortizing the initial $200 commission and the $120 renewal commission:

- **Approach 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:

<table>
<thead>
<tr>
<th>Initial Contract</th>
<th>Renewal Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Initial commission</td>
<td>$ 50</td>
</tr>
<tr>
<td>Renewal commission</td>
<td></td>
</tr>
<tr>
<td>Total expense recognized</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

- **Approach 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:

<table>
<thead>
<tr>
<th>Initial Contract</th>
<th>Renewal Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Initial commission — Part 1 ($120)</td>
<td>$ 60</td>
</tr>
<tr>
<td>Initial commission — Part 2 ($80 remainder)</td>
<td>20</td>
</tr>
<tr>
<td>Renewal commission</td>
<td></td>
</tr>
<tr>
<td>Total expense recognized</td>
<td>$ 80</td>
</tr>
</tbody>
</table>

As noted in Example 13-16 above, we believe that there are multiple acceptable approaches to amortizing costs of obtaining contract assets when commissions paid upon renewal are not commensurate with the initial commission paid. Example 13-17 below illustrates how the alternatives may be applied when a good or service is transferred at the inception of an arrangement and another good or service is transferred over time.
Example 13-17

Software Company

Company A enters into a software arrangement with a customer in exchange for consideration of $1,300. Under the arrangement, A provides a software license ($1,000) and three years of postcontract customer support (PCS) ($100 per year). In addition, the arrangement includes two years of optional PCS renewals for which the customer is able to renew at $100 per year. At contract inception, A expects that the customer will renew the PCS for both years. The corresponding commission rates for the software license and PCS (including renewals) are as follows:

<table>
<thead>
<tr>
<th>Goods and Services</th>
<th>Price</th>
<th>Commission Rate</th>
<th>Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software license</td>
<td>$ 1,000</td>
<td>10%</td>
<td>$ 100</td>
</tr>
<tr>
<td>Year 1 PCS</td>
<td>100</td>
<td>10%</td>
<td>10</td>
</tr>
<tr>
<td>Year 2 PCS</td>
<td>100</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>Year 3 PCS</td>
<td>100</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>Initial contract value</td>
<td>1,300</td>
<td></td>
<td>Initial commission 120</td>
</tr>
<tr>
<td>Year 4 PCS (expected)</td>
<td>100</td>
<td>1%</td>
<td>1</td>
</tr>
<tr>
<td>Year 5 PCS (expected)</td>
<td>100</td>
<td>1%</td>
<td>1</td>
</tr>
<tr>
<td>Total value</td>
<td>1,500</td>
<td></td>
<td>Total commission $ 122</td>
</tr>
<tr>
<td>Initial contract commission</td>
<td>120</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total consideration</td>
<td>1,500</td>
<td></td>
<td>122</td>
</tr>
</tbody>
</table>

For purposes of this example, assume that revenue is recognized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software license</td>
<td>$ 1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PCS</td>
<td>100</td>
<td>$ 100</td>
<td>$ 100</td>
<td>$ 100</td>
<td>$ 100</td>
</tr>
<tr>
<td>Total revenue</td>
<td>$ 1,100</td>
<td>$ 100</td>
<td>$ 100</td>
<td>$ 100</td>
<td>$ 100</td>
</tr>
</tbody>
</table>
Example 13-17 (continued)

As illustrated above, the commission paid upon PCS renewal in years 4 and 5 is not commensurate with the commission paid on PCS in the initial contract; therefore, the initial commission is related to both the original contract and the renewal periods. We believe that in this example, there are at least two acceptable approaches to amortizing the initial $120 commission and the $2 renewal commission:

- **Approach 1** — Amortize the initial commission amount of $120 proportionately over the contract period that includes the anticipated renewals (e.g., five years) by multiplying the annual revenue amount in each year by Percentage 1. The incremental commission from years 4 and 5 would be amortized over the remaining two-year period, as shown in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Initial Contract</th>
<th>Renewal Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Initial commission</td>
<td>$88</td>
<td>$8</td>
</tr>
<tr>
<td>Renewal commission</td>
<td>______</td>
<td>______</td>
</tr>
<tr>
<td>Total expense recognized</td>
<td>$88</td>
<td>$8</td>
</tr>
</tbody>
</table>

- **Approach 2** — Amortize the total expected commission amount of $122 over the contract period that includes the anticipated renewals (e.g., five years) by multiplying the annual revenue amount by Percentage 2, as shown in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Initial Contract</th>
<th>Renewal Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Total commission</td>
<td>$90</td>
<td>$8</td>
</tr>
<tr>
<td>Total expense recognized</td>
<td>$90</td>
<td>$8</td>
</tr>
</tbody>
</table>

The above issue is addressed in Implementation Q&A 71 (compiled from previously issued TRG Agenda Papers 23, 25, 57, and 60). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

13.4.1.3 Accounting for Unamortized Contract Costs Upon Modification

ASC 606-10-25-13(a) provides that when specified criteria are met, an entity should account for a contract modification “as if it were a termination of the existing contract, and the creation of a new contract.” Although the contract modification is accounted for as if it were a termination of the existing contract and the creation of a new contract, the original contract was not in fact terminated. Therefore, any unamortized contract costs that existed immediately before the contract modification should not be written off unless those costs are no longer related to the remaining goods or services. Rather, those unamortized contract costs should be carried forward into the new contract and amortized on a systematic and rational basis that is consistent with the transfer of goods or services related to the asset.

An entity will need to use judgment when determining which remaining goods or services to be transferred under the modified contract are related to the asset (see Section 13.4.1.2). Further, the entity should consider whether the asset is impaired by applying the guidance in ASC 340-40-35-3 through 35-5 (see Section 13.4.2 below).
13.4.2 Impairment

**ASC 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 amount of consideration that the entity expects to receive in the future and that the entity has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates (“the consideration”), less

b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraphs 340-40-25-2 and 340-40-25-7).

35-4 For the purposes of applying paragraph 340-40-35-3 to determine the consideration, 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. When determining the consideration for the purposes of paragraph 340-40-35-3, an entity also shall consider expected contract renewals and extensions (with the same customer).

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 other than Topic 340 on other assets and deferred costs, Topic 350 on goodwill and other intangible assets, or Topic 360 on property, plant, and equipment (for example, Topic 330 on inventory and Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed). 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.

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 IFRS Standards 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.

To test a contract cost asset for impairment, an entity must consider the total period over which it expects to receive an economic benefit from the 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 (e.g., a contract renewal). However, the impairment guidance as originally issued in ASU 2014-09 appeared to contradict itself because it also indicated 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.” The determination of the transaction price would exclude renewals.⁶ ⁷

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⁶ ASC 340-40-35-4 (paragraph 102 of IFRS 15).
⁷ 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 cost 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.

As a result of the TRG discussions noted above, the FASB issued ASU 2016-20, which includes certain technical corrections that 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.

13.5 Onerous Performance Obligations

Both U.S. GAAP and IFRS Standards 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 this condition is met, the guidance may require an entity to recognize the expected future loss before actually incurring the loss. Onerous contracts have historically been accounted for as follows:

- **U.S. GAAP** — As indicated in ASC 605-10-05-4, existing guidance under U.S. GAAP addresses the recognition of losses on the following specific transactions:
  - 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. Further, ASC 330-10-35-17 and 35-18 provide guidance on the recognition of losses on firm purchase commitments related to inventory.

- **IFRS Standards** — 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) believed 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 [Standards].”

Many stakeholders disagreed with including an onerous test in the new revenue standard. Those stakeholders provided feedback indicating that application of an 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 believed that the existing 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 IFRS Standards sufficiently addresses onerous contracts. Consequently, the boards decided not to include specific guidance on accounting for onerous contracts in the new revenue standard.

**Connecting the Dots — Onerous Contracts**

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 IFRS Standards. 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 IFRS Standards; however, differences in the accounting for onerous contracts will remain. While the existing 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.

### 13.5.1 Technical Corrections to ASC 605-35-25

The new revenue standard supersedes most of the guidance in ASC 605-35-25. However, the existing guidance in ASC 605-35-25 on provision for loss contracts was retained because the FASB decided not to include specific guidance on onerous contracts in the new revenue standard but to retain the practice under U.S. GAAP of recording losses for onerous contracts within the scope of ASC 605-35. The technical corrections of ASU 2016-20 include an update to ASC 605-35-25 that allows an entity to determine the provision for losses on contracts within the scope of ASC 605-35 at the performance obligation level or the contract level as an accounting policy election.
13.5.2 Application of the Loss Guidance in ASC 605-35 That Affects Impairment of Capitalized Contract Cost Assets

Example 13-18 below illustrates how to record an impairment of an asset related to the capitalized costs of fulfilling a contract in a manner consistent with the guidance in ASC 605-35-45-2.

Example 13-18

Company M provides a cleaning and restoration service for certain outdoor spaces after natural disasters have occurred. On June 30, 20X0, M enters into a contract with a customer to clean up and restore a beach after a disastrous hurricane. Since the service that M provides under the contract requires the use of construction vehicles and the assembly of temporary infrastructure (e.g., a piping system for moving sand or water to and from various locations), M incurs significant up-front costs to fulfill the contract. Company M expects that the costs of mobilizing the necessary construction vehicles and assembling the temporary infrastructure will be recovered through the contract with the customer. In addition, M determines that it should recognize revenue from the contract over time by using an input method based on costs incurred.

At contract inception, M estimates or determines the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction price</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Estimated total costs at completion (EAC)</td>
<td>$1,500,000 (inclusive of the $200,000 capitalized costs of fulfilling the contract)</td>
</tr>
<tr>
<td>Estimated profit/(loss)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Capitalized costs of fulfilling the contract</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

One year later, on June 30, 20X1, M updates its EAC calculation and now expects to incur a loss on the contract. The updated calculations are as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction price</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>EAC</td>
<td>$2,300,000</td>
</tr>
<tr>
<td>Estimated profit/(loss)</td>
<td>$(300,000)</td>
</tr>
<tr>
<td>Capitalized costs of fulfilling the contract</td>
<td>$120,000*</td>
</tr>
</tbody>
</table>

* As of June 30, 20X1, M had amortized $80,000 of the initial $200,000 costs capitalized in accordance with ASC 340-40. As a result, $120,000 remains recognized as an asset before any adjustment attributable to the loss position of the contract.

As a result, M will recognize the expected contract loss immediately (as of June 30, 20X1) in accordance with the guidance in ASC 605-35 in the amount of $300,000. Note that M will also have to record a cumulative catch-up adjustment to revenue in the same period (as of June 30, 20X1).

Company M should first record an impairment of the asset related to the capitalized costs of fulfilling the contract. If the expected loss on the contract caused an impairment of the entire asset related to the capitalized costs of fulfilling the contract, M should then account for the remainder of the expected loss as a loss reserve, which would be classified as a liability on M's balance sheet. Recording impairment in this order is consistent with the guidance in ASC 605-35-45-2, which states the following:

Provisions for losses on contracts shall be shown separately as liabilities on the balance sheet, if significant, except in circumstances in which related costs are accumulated on the balance sheet, in which case the provisions may be deducted from the related accumulated costs. In a classified balance sheet, a provision shown as a liability shall be shown as a current liability. [Emphasis added]

On the basis of the guidance above, which was issued before the guidance in ASC 606 but has not been amended or superseded, the expected loss first impairs the capitalized contract costs of fulfilling the contract. Subsequently, a provision for a loss is established on the balance sheet.

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8 For simplicity, any adjusting revenue entry (and any corresponding adjustment to the loss provision) is not illustrated in this example.
Example 13-18 (continued)

Company M should record the following journal entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract cost (expense)</td>
<td>300,000</td>
</tr>
<tr>
<td>Contract fulfillment costs (asset)</td>
<td>120,000</td>
</tr>
<tr>
<td>Contract loss reserve (liability)</td>
<td>180,000</td>
</tr>
</tbody>
</table>

Since the expected loss on the contract ($300,000) is larger than the remaining asset related to the capitalized costs of fulfilling the contract ($120,000), M needs to establish a loss reserve (liability) to account for the remainder of the expected loss ($180,000).
Chapter 14 — Presentation

14.1 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 (or receivable) 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 remaining 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 (e.g., 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:

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-5</strong> This guidance uses the terms <em>contract asset</em> and <em>contract liability</em> 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.</td>
</tr>
</tbody>
</table>

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 legacy 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.

### 14.2 Contract Liabilities

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-2</strong> 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.</td>
</tr>
</tbody>
</table>

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 14.5.)

### 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).

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Contract Liability</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

b. The entity satisfies the performance obligation on March 31, 20X9.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Liability</td>
<td>$1,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Case B — Noncancellable Contract**

55-285 The same facts as in Case A apply to Case B except that the contract becomes noncancellable on January 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. January 31, 20X9 is the date at which the entity recognizes a receivable because it has an unconditional right to consideration.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable</td>
<td>$1,000</td>
</tr>
<tr>
<td>Contract Liability</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

b. The entity receives the cash on March 1, 20X9.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Receivable</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

c. The entity satisfies the performance obligation on March 31, 20X9.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Liability</td>
<td>$1,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

55-286 If the entity issued the invoice before January 31, 20X9, the entity would not recognize the receivable and the contract liability in the statement of financial position because the entity does not yet have a right to consideration that is unconditional (the contract is cancellable before January 31, 20X9).

#### 14.3 Refund Liabilities

Some contracts with customers may result in refund liabilities owed to customers. The most common of such refund liabilities are return provisions in sales contracts that permit the customer to return the product if certain circumstances arise. These liabilities may also arise when an entity receives cash in advance, but the agreement is cancelable because of certain termination provisions in the agreement (see Section 4.4.1). When these provisions are present in a contract, the seller would recognize a liability to reflect its obligation to return amounts paid or payable by the customer (i.e., a refund liability).
A refund liability should not be presented together with contract liabilities that arise under the same contract. A contract liability is defined in ASC 606-10-45-2 as “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 refund liability, however, represents the customer’s conditional right to consideration from the seller (as opposed to consideration receivable from the customer) and does not represent a performance obligation. Consequently, we believe that the refund liability should be presented separately from the contract liability. Note that as a result, the refund liability would not be netted with any contract assets the entity may recognize.

Example 14-1

Entity A sells Product X to 10 separate customers for $100 each and does not charge a restocking fee. On the basis of its historic experience, A expects that one of these products will be returned. As a result, A should recognize a refund liability of $100 for the one product out of 10 that it expects will be returned. In addition to Product X, A also sells Product Z (considered a separate performance obligation from Product X). One customer has prepaid for Product Z in the amount of $1,000. As a result, A has recorded a contract liability of $1,000.

In accordance with the guidance above, A should record a refund liability of $100 and a separate contract liability of $1,000 (i.e., A should not present the refund liability together with the contract liability).

For a discussion about offsetting refund liabilities against accounts receivable, see Example 14-6.

14.4 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 credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

Pending Content (Transition Guidance: ASC 326-10-65-1)

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 credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (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 (e.g., 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:
Example 39 — Contract Asset Recognized for the Entity’s Performance

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.

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.

The entity satisfies the performance obligation to transfer Product A.

<table>
<thead>
<tr>
<th>Contract asset</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$400</td>
<td>$400</td>
</tr>
</tbody>
</table>

The entity satisfies the performance obligation to transfer Product B and to recognize the unconditional right to consideration.

<table>
<thead>
<tr>
<th>Receivable</th>
<th>Contract asset</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>$400</td>
<td>$600</td>
</tr>
</tbody>
</table>

14.5 Receivables

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).

Pending Content (Transition Guidance: ASC 326-10-65-1)

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 Subtopic 326-20 and the corresponding amount of revenue recognized shall be presented 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 an entity's right to consideration, the risks associated with each differ. As noted in Section 14.1, 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 (e.g., 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 6.3.5.2) and the amount of revenue recognized. However, an entity's present right to consideration may 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 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).

**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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable</td>
<td>$15,000(1)</td>
</tr>
<tr>
<td>Revenue</td>
<td>$12,500(2)</td>
</tr>
<tr>
<td>Refund liability</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

(1) $150 per product × 100 products

(2) $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).
Connecting the Dots — 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 could have resulted from the wording in Example 38, Case B, of the new revenue standard (reproduced in Section 14.2), which some believed was not aligned with the guidance that identifies a receivable as a right to consideration as a right to consideration that is unconditional other than for the passage of time. Partly in response to stakeholders’ concerns acknowledged at the meeting, the FASB later issued ASU 2016-20, which contains guidance aimed at clarifying the timing of revenue recognition related to receivables (referred to in ASU 2016-20 as “Issue 9”). See Section 20.3.3.6 for further information about the ASU’s clarifications related to Issue 9.

At the TRG meeting, the staff also 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 observed 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.

Example 14-2 below illustrates how an entity that satisfies its sole performance obligation in a contract with a customer and plans to invoice the customer in multiple annual installments should reflect the transaction on its balance sheet.

**Example 14-2**

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 on March 1, 20X1) 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.

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 because the sole performance obligation has been satisfied as of March 1, 20X1 (i.e., A has an unconditional right to cash for the full contract amount).
Example 14-3 below illustrates how an entity that satisfies its performance obligation over time in its contracts with customers and plans to invoice each customer with different payment terms should reflect the transactions on its balance sheet.

**Example 14-3**

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:

- **Alternative 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

- **Alternative 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 Alternative A or Alternative B could be acceptable.
Connecting the Dots — Allocation of Cash Payments to Performance

As further discussed in Section 14.7.1, contract assets and contract liabilities should be determined at the contract level (i.e., not at the performance obligation level), and 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, as also discussed in Section 14.7.1. This issue is addressed in Q&As 61 through 63 (compiled from previously issued TRG Agenda Papers 7 and 11) of the FASB staff's Revenue Recognition Implementation Q&As (the "Implementation Q&As"). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

Implementation Q&A 34 (compiled from previously issued TRG Agenda Papers 30 and 34) discusses 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 7.7 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 Example 14-4 below.

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**Example 14-4**

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 ($1,200). 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.
Example 14-4 (continued)

There are multiple views on how this transaction should be presented as of and for the period ended March 31, 20X1:

- **Alternative 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 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 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.

- **Alternative 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 a 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* 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 Alternative B, the entity would also record a receivable 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 Alternative A or Alternative B could be acceptable. Entities should apply a consistent approach for similar contracts and in similar circumstances.
14.6 Classification as Current or Noncurrent

If an entity presents a classified balance sheet, it should determine whether certain revenue-related balances should be presented as current or noncurrent (or bifurcated between the two).

14.6.1 Contract Assets and Contract Liabilities

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 14.7.1) is the contract asset or contract liability that should be bifurcated between current and noncurrent when presented in a classified balance sheet.

14.6.2 Refund Liabilities

Example 14-5 below considers whether it is appropriate for an entity to classify refund liabilities (or similar liabilities) as a noncurrent liability in a classified balance sheet.

Example 14-5

Entity P, an entity with an operating cycle of less than 12 months, expects to return proceeds related to refund liabilities (or similar liabilities) more than 12 months after the reporting date. However, the counterparty can demand a refund of amounts previously paid at any time.

Entity P should not classify the portion that it expects to repay more than 12 months after the reporting date as a noncurrent liability in a classified balance sheet. All amounts related to such liabilities should be recorded as a current liability because the counterparty can demand a refund at any time.

ASC 470-10-45-10, which specifies that loans due on demand should be presented as a current liability, supports this view. The guidance in that paragraph states, in part:

The current liability classification shall include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period.

14.6.3 Capitalized Contract Costs

It is acceptable for costs of obtaining or fulfilling a contract to be bifurcated between current and noncurrent in a classified balance sheet. Alternatively, in a manner similar to the treatment of (1) intangible assets, (2) inventory, or (3) property, plant, and equipment, capitalized costs of obtaining or fulfilling a contract may 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.

14.7 Other Presentation Matters

14.7.1 Unit of Account for Presentation

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. In such circumstances, 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 the “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 Section 14.7.2.1 for discussion of offsetting contract assets and contract liabilities against other assets and liabilities.

Unit of account considerations for presentation purposes are addressed in Implementation Q&As 61 through 63 (compiled from previously issued TRG Agenda Papers 7 and 11). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

**Connecting the Dots — Accounting for Contract Assets and Contract Liabilities in Contracts That Include Consideration in a Foreign Currency**

As a corollary to the discussion in Section 6.3.5.5.1 that variability due to changes in the foreign currency exchange is not variable consideration, questions have been raised about the accounting for receivables, contract assets, and contract liabilities in contracts that include consideration denominated in a foreign currency. Specifically, stakeholders have asked how an entity should apply the guidance in ASC 830 on foreign currency matters to the recognized assets and liabilities in a customer contract with the expectation that more contract assets may arise in contracts under ASC 606.

ASC 606 requires an entity to recognize (1) a contract asset if the entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due or (2) a contract liability if the entity receives (or has an unconditional right to receive) consideration before it transfers goods or services to the customer. This requirement is similar to the requirement under the legacy guidance in ASC 605-35 related to the recognition of costs in excess of billings and billings in excess of costs.

Like billings in excess of costs, contract liabilities are nonmonetary liabilities because they require an entity to perform a service in the future. Contract assets are monetary assets for the same reason that costs in excess of billings are monetary assets under legacy guidance. That is, contract assets will ultimately be settled for a fixed amount of cash.
A separate issue arises if a single contract with a customer contains a performance obligation that is in a contract asset position and another performance obligation that is in a contract liability position. ASC 606 requires an entity to present contract assets and contract liabilities on a net basis in the balance sheet. Therefore, questions have arisen about whether the guidance in ASC 830 should be applied to the gross contract asset and liability balances separately or only to the net contract asset or liability for a single contract. We believe that the guidance in ASC 830 should be applied on a gross basis. For a complete discussion of this issue, see Section 4.8 of Deloitte’s A Roadmap to Foreign Currency Transactions andTranslations.

14.7.2 Balance Sheet Offsetting

14.7.2.1 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 (e.g., receivables), and provisions as defined in ASC 460.

In practice, it will not be possible for entities to offset contract assets and contract liabilities against other assets and liabilities given that the contract assets and contract liabilities do not represent determinable amounts owed by each party. 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 above issue is addressed in Implementation Q&A 63 (compiled from previously issued TRG Agenda Papers 7 and 11). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see Appendix C.

14.7.2.2 Offsetting Refund Liabilities Against Accounts Receivable

For an entity to offset refund liabilities against accounts receivable, all of the following criteria in ASC 210-20-45-1 must be met:

a. Each of two parties owes the other determinable amounts.

b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.
Example 14-6 below illustrates how to determine whether it is permissible to offset a refund liability against accounts receivable.

**Example 14-6**

Company P manufactures widgets and sells them to various retailers, which ultimately sell the widgets to end customers. Company P has concluded that the retailers are its customers and that control of the widgets is transferred to the retailers upon delivery to them. Upon receipt of the widgets, retailers have 90 days to return any unsold widgets to P. If a retailer exercises its right to return a widget, P provides a credit against the retailer's accounts receivable balance. That is, P does not pay cash to settle the refund liability; rather, it offsets the refund liability against any currently outstanding accounts receivable.\(^1\) In accordance with ASC 606-10-32-10, P estimates a refund liability for widgets that it expects retailers to return.

Company P must evaluate the criteria in ASC 210-20 to determine whether it is permitted to offset the refund liability against accounts receivable in P's balance sheet.

In practice, P may not have the legal right to offset the refund liability against amounts receivable from a retailer. Further, the estimated refund liability may not represent a determinable amount because P estimated the refund liability by using a portfolio of information.

The notion that an entity should apply ASC 210-20 to determine whether offsetting is appropriate is consistent with the considerations related to offsetting contract assets and contract liabilities against other assets and liabilities (see Section 14.7.2.1 for a discussion of that issue).

The above issue is addressed Implementation Q&A 63 (compiled from previously issued TRG Agenda Papers 7 and 11). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see Appendix C.

### 14.7.3 Income Statement Classification of Interest

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.

For purposes of the consolidated financial statements, the interest income generated from certain financing arrangements may be classified as revenue in the income statement. 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.

---

\(^1\) Company P would pay cash to settle the refund liability only if the customer did not have an outstanding accounts receivable balance.
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.

Examples 14-7 and 14-8 below demonstrate the concepts explained above.

**Example 14-7**

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 14-8**

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.

### 14.7.4 Income Statement Classification of Amortized Contract Costs

Generally, the amortization of any incremental costs of obtaining a contract that are capitalized under ASC 340-40 should be classified in the income statement as selling, general, and administrative (SG&A) expense.

Under ASC 340-40, an entity is required to recognize the incremental costs of obtaining a contract (i.e., those costs that would not have been incurred if the contract had not been obtained) as an asset if the entity expects to recover them. When capitalized, the costs 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.” However, ASC 340-40 does not include guidance on the presentation of amortized contract costs in the income statement.

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2 ASC 340-40-25-4 provides a practical expedient under which “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.”
In addition, the Codification does not contain guidance on the types of expenses that represent SG&A expense or cost of sales. SEC Regulation S-X, Rule 5-03(b), provides limited guidance by indicating the various line items that should appear on the face of the income statement (if applicable). Rule 5-03(b) indicates that the cost of any tangible goods sold and the cost of any services sold are “[c]costs and expenses applicable to sales and revenues.” Further, Rule 5-03(b) requires a separate line item for SG&A expenses.

Despite the limited authoritative guidance, we believe that SG&A expense in the income statement would be the preferred classification of the amortization of incremental costs of obtaining a contract that are capitalized under ASC 340-40. This is because such costs represent costs of acquiring a contract (e.g., selling costs), as opposed to costs of fulfilling a contract that generally would be included in cost of goods sold (or a similar line item).

14.7.5 Income Statement Presentation of Reimbursements for Out-of-Pocket Expenses

ASC 606 does not explicitly address out-of-pocket reimbursements. However, ASC 606-10-32-2 defines the 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, excluding amounts collected on behalf of third parties (for example, some sales taxes).” Therefore, generally all consideration provided to the entity from the customer should be included in the transaction price and allocated to the promised goods or services identified in the contract.

In addition, we believe that the outcomes under ASC 606 should typically align with the legacy guidance in ASC 605. Specifically, ASC 605-45-45-22 and 45-23 address reimbursements for out-of-pocket expenses, and ASC 605-45-45-23 states that “[r]eimbursements received for out-of-pocket expenses incurred shall be characterized as revenue in the income statement.” This guidance under ASC 605 was codified on the basis of EITF Issue 01-14, on which the EITF reached a consensus that “reimbursements received for out-of-pocket expenses incurred should be characterized as revenue in the income statement.” This consensus was principally supported by EITF Issues 99-19 and 00-10.

In reaching a consensus on Issue 01-14, the EITF agreed that the following factors in Issue 99-19 are indicators that reimbursements received for out-of-pocket expenses could be characterized as revenue:

- **Primary obligor** — The “service provider (seller) is the primary obligor with respect to purchasing goods and services from third-party suppliers, such as airlines.”
- **Supplier discretion** — The “service provider (seller) generally has discretion in selecting the supplier.”
- **Credit risk** — The “service provider (seller) generally has credit risk because it typically receives reimbursement after the goods or services have been purchased.”

The EITF also agreed that the following factors in Issue 99-19 are indicators that reimbursements received for out-of-pocket expenses incurred could be characterized as a reduction of expenses incurred:

- **Pricing** — The “service provider (seller) typically has no latitude in establishing the reimbursement price for the out-of-pocket expenses. Contractually, the service provider (seller) typically must invoice its customers for those expenses in an amount equal to the amount of the costs incurred.”
• Zero margin — The “service provider (seller) earns no margin (that is, the price on the out-of-pocket expenses is fixed) because the arrangements generally state that those expenses are to be billed based on the actual cost incurred.”

The EITF’s conclusions are related, in part, to the expectation that a contract’s pricing could take many forms and that while costs in a contract may sometimes be characterized as reimbursements of costs, they may in other instances be embedded in the underlying cost of the service delivered. If an entity treats such costs as part of the transaction price regardless of how they are characterized in the contract, the entity will report revenue in a consistent manner.

Example 14-9 below illustrates how to present reimbursements received from a customer for out-of-pocket expenses.

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**Example 14-9**

Company X enters into an agreement to identify and acquire specified goods on behalf of Customer P from a third party for which X will earn a commission calculated as a percentage of the agreed purchase price. Company X has determined that it is acting as an agent in this arrangement, in accordance with ASC 606-10-55-36 through 55-40. In addition, as part of the agreement, P will reimburse X for reasonable out-of-pocket expenses (e.g., hotels, meals, transportation). Consequently, X must determine how to present the out-of-pocket expenses and reimbursements.

Company X should first determine the nature of the out-of-pocket expenses reimbursed by P. If such costs are incurred for X to fulfill its agency service and are not incurred on behalf of P, X’s out-of-pocket costs and related reimbursements should generally be presented gross. Alternatively, if in the course of providing its agency services to P, X were to incur and be reimbursed for costs on behalf of P that provide a good or service to P, such costs should generally be presented net.

Assume that X determines that its reimbursable out-of-pocket expenses (e.g., hotels, meals, transportation) are common expenses in its industry and do not provide a good or service to P. On the basis of this determination, X will include any amounts collected (or expected to be collected) as reimbursements in the transaction price for the agency service delivered to P. As a result, such reimbursements will be presented gross in X’s income statement.
Chapter 15 — Disclosure

15.1 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, while disclosure has been a focus of the FASB and SEC in recent years, that focus has been primarily related to disclosure overload and extensive disclosures required on topics such as pensions, stock compensation, fair value, and income taxes. In response to stakeholder feedback, the FASB has aimed to make disclosures more effective, better coordinated, and less redundant. Although this has been an overall focus of the FASB and SEC, the lack of disclosure on revenue 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).

**Connecting the Dots — System and Implementation Challenges**

As discussed in Section 1.9.2, 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 legacy revenue guidance. 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 revenue disclosures, the boards introduced new and expanded disclosure requirements, which are both quantitative and qualitative as well as significantly more comprehensive than legacy guidance. Meeting these disclosure requirements will require significant judgment. Some disclosures may be applicable for some entities while immaterial or extraneous for others.

See Deloitte's July 11, 2018, *Heads Up* for additional information about the disclosures required under the new revenue standard and examples of such disclosures.

**15.1.1 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,” (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,” and (3) not repeat disclosures if the information is already presented in the manner required by other accounting standards.

15.1.2 Disclosures in Comparative and Interim 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 Sections 16.2.1.2 and 16.2.2.3 for a discussion of the disclosures that are required upon adoption under the full retrospective and modified retrospective methods, respectively.

Throughout this chapter of the Roadmap, we provide illustrative examples that highlight certain aspects of the new disclosure guidance and reflect our views on how that guidance might be applied. However, these examples are not intended to be templates or comprehensive resources. Rather, they should be regarded as tools to help entities consider key judgments and issues 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 17).

Annual Disclosures

<table>
<thead>
<tr>
<th>Disclosures About Contracts With Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disaggregation of revenue</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Disclosures About Significant Judgments and Estimates</th>
<th>Other Required Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description of significant judgments</td>
<td>Transaction price, allocation methods, and assumptions</td>
</tr>
<tr>
<td></td>
<td>Practical expedients</td>
</tr>
<tr>
<td></td>
<td>Contract costs</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Disclosures About Contracts With Customers</th>
<th>Other Required Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disaggregation of revenue</td>
<td>Description of significant judgments</td>
</tr>
<tr>
<td>Information about contract balances</td>
<td>Transaction price, allocation methods, and assumptions</td>
</tr>
<tr>
<td>Remaining performance obligations</td>
<td>Practical expedients</td>
</tr>
<tr>
<td>Information about performance obligations</td>
<td>Contract costs</td>
</tr>
</tbody>
</table>

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.

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 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, paragraph 606-10-50-2 clarifies that an entity need not disclose information that is immaterial.

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3 IAS 34 provides the interim disclosure requirements under IFRS Standards. 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 more information about differences between U.S. GAAP and IFRS Standards on revenue-related topics, see Appendix A.
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 immaterial 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 specifies that an entity should evaluate the level of detail to provide in its required disclosures and the amount of emphasis to place on each disclosure requirement.

Accordingly, the level of detail or prominence 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 relevant and material (e.g., as a result of increases in the monetary values to be disclosed or changes in qualitative factors).

### 15.1.4 Summary of Disclosure Requirements, Including Election for Nonpublic Entities and Interim Requirements

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disaggregation of revenue</td>
<td>Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors.</td>
<td>Yes⁵</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment’s revenue information.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contract balances</td>
<td>Opening and closing balances (receivable, contract assets, and contract liabilities).</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Amount of revenue recognized from beginning contract liability balance.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Explanation of significant changes in contract balances (using qualitative and quantitative information).</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

---

⁴ This column represents the interim disclosure requirements in years after the year of adoption of the new revenue standard. Refer to Section 15.6 for information about interim disclosure requirements in the year of adoption.

⁵ At a minimum, a nonpublic 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) and qualitative information about how economic factors affect revenue and cash flows.
(Table continued)

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance obligations (including remaining performance obligations)</td>
<td>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 of refunds, and (5) warranties.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Transaction price allocated to the remaining performance obligations:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Disclosure of quantitative amounts.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>• Qualitative or qualitative explanation of when remaining performance obligation amounts will be recognized as revenue.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Significant judgments and estimates</td>
<td>Qualitative information about determining the timing of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
<td>Yes⁶</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• Performance obligations satisfied at a point in time — specifically, the significant judgments used in the evaluation of when a customer obtains control.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Qualitative and quantitative information⁷ about:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration).</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• Constraining estimates of variable consideration.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• Measuring obligations for returns, refunds, and other similar obligations.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

⁶ The election available to nonpublic entities applies only to the requirement to disclose information about why the methods used to recognize revenue over time provide a faithful depiction of the transfer of goods or services to a customer. Nonpublic entities are still required to disclose the information about the methods used to recognize revenue over time in accordance with ASC 606-10-50-18(a).

⁷ This includes the methods, inputs, and assumptions used in an entity’s assessment.
### Category Disclosure Requirements

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract costs</td>
<td>Qualitative information about:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Judgments made in determining the amount of the costs incurred to obtain or fulfill a contract.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• The method the entity uses to determine the amortization for each reporting period.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Quantitative information about:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• The amount of amortization and any impairment losses recognized in the reporting period.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

### Practical expedients

- Disclosure of practical expedients used.
- Yes
- No

### 15.2 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.

**Pending Content (Transition Guidance: ASC 326-10-53-1)**

**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. 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 leasing 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:

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disaggregation of revenue</td>
<td>Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors.</td>
<td>Yes*</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* See footnote 5.
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 typically 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 Topic 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 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.

**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.
Examples of categories that might be appropriate include, but are not limited to, all of the following:

- Type of good or service (for example, major product lines)
- Geographical region (for example, country or region)
- Market or type of customer (for example, government and nongovernment customers)
- Type of contract (for example, fixed-price and time-and-materials contracts)
- Contract duration (for example, short-term and long-term contracts)
- 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)
- Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

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.

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:

Example 41 — Disaggregation of Revenue — Quantitative Disclosure

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).
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.

<table>
<thead>
<tr>
<th>Segments</th>
<th>Consumer Products</th>
<th>Transportation</th>
<th>Energy</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary Geographical Markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$ 990</td>
<td>$ 2,250</td>
<td>$ 5,250</td>
<td>$ 8,490</td>
</tr>
<tr>
<td>Europe</td>
<td>300</td>
<td>750</td>
<td>1,000</td>
<td>2,050</td>
</tr>
<tr>
<td>Asia</td>
<td>700</td>
<td>260</td>
<td></td>
<td>960</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$ 1,990</strong></td>
<td><strong>$ 3,260</strong></td>
<td><strong>$ 6,250</strong></td>
<td><strong>$ 11,500</strong></td>
</tr>
<tr>
<td><strong>Major Goods/Service Lines</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office supplies</td>
<td>$ 600</td>
<td>—</td>
<td>—</td>
<td>$ 600</td>
</tr>
<tr>
<td>Appliances</td>
<td>990</td>
<td>—</td>
<td>—</td>
<td>990</td>
</tr>
<tr>
<td>Clothing</td>
<td>400</td>
<td>—</td>
<td>—</td>
<td>400</td>
</tr>
<tr>
<td>Motorcycles</td>
<td>—</td>
<td>500</td>
<td>—</td>
<td>500</td>
</tr>
<tr>
<td>Automobiles</td>
<td>—</td>
<td>2,760</td>
<td>—</td>
<td>2,760</td>
</tr>
<tr>
<td>Solar panels</td>
<td>—</td>
<td>—</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Power plant</td>
<td>—</td>
<td>—</td>
<td>5,250</td>
<td>5,250</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$ 1,990</strong></td>
<td><strong>$ 3,260</strong></td>
<td><strong>$ 6,250</strong></td>
<td><strong>$ 11,500</strong></td>
</tr>
<tr>
<td><strong>Timing of Revenue Recognition</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods transferred at a point in time</td>
<td>$ 1,990</td>
<td>$ 3,260</td>
<td>$ 1,000</td>
<td>$ 6,250</td>
</tr>
<tr>
<td>Services transferred over time</td>
<td>—</td>
<td>—</td>
<td>5,250</td>
<td>5,250</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$ 1,990</strong></td>
<td><strong>$ 3,260</strong></td>
<td><strong>$ 6,250</strong></td>
<td><strong>$ 11,500</strong></td>
</tr>
</tbody>
</table>

**Connecting the Dots — Determining the Level of Disaggregation**

For many 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 historical challenges related to segment disclosures and the new revenue standard’s requirements related to disaggregation, 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.”
At the 2016 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff highlighted that the disclosure guidance in ASC 606 on disaggregation of revenue is similar to the segment reporting guidance, but it noted that ASC 606 does not provide an impracticability exception. Further, the SEC staff stated that its reviews of filings will include reviews of other materials, such as investor presentations and earnings releases, to determine whether the appropriate amount of disaggregation is disclosed.

The following illustrative disclosure of a company’s disaggregation of revenue (adapted from Example 41 of ASC 606) highlights some of the questions an entity may think about when applying the guidance on disaggregating revenue balances:

**Illustrative Disclosure — Disaggregation of Revenue**

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.

<table>
<thead>
<tr>
<th>Segments</th>
<th>Segment A</th>
<th>Segment B</th>
<th>Segment C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary Geographical Markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$10</td>
<td>$20</td>
<td>$50</td>
<td>$80</td>
</tr>
<tr>
<td>Europe</td>
<td>70</td>
<td>10</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>Asia</td>
<td>60</td>
<td>20</td>
<td>—</td>
<td>80</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$140</td>
<td>$50</td>
<td>$60</td>
<td>$250</td>
</tr>
<tr>
<td><strong>Major Goods/Service Lines</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Major goods Category A</td>
<td>$100</td>
<td>—</td>
<td>$ —</td>
<td>$100</td>
</tr>
<tr>
<td>Major goods Category B</td>
<td>40</td>
<td>—</td>
<td>—</td>
<td>40</td>
</tr>
<tr>
<td>Major goods Category C</td>
<td>—</td>
<td>20</td>
<td>—</td>
<td>20</td>
</tr>
<tr>
<td>Major goods Category D</td>
<td>—</td>
<td>25</td>
<td>—</td>
<td>25</td>
</tr>
<tr>
<td>Service Line A</td>
<td>—</td>
<td>5</td>
<td>40</td>
<td>45</td>
</tr>
<tr>
<td>Service Line B</td>
<td>—</td>
<td>—</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$140</td>
<td>$50</td>
<td>$60</td>
<td>$250</td>
</tr>
<tr>
<td><strong>Timing of Revenue Recognition</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods transferred at a point in time</td>
<td>$140</td>
<td>$45</td>
<td>$ —</td>
<td>$185</td>
</tr>
<tr>
<td>Services transferred over time</td>
<td>—</td>
<td>5</td>
<td>60</td>
<td>65</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$140</td>
<td>$50</td>
<td>$60</td>
<td>$250</td>
</tr>
</tbody>
</table>

What entity- or industry-specific factors are most meaningful to your business?

Is this information already available?

Where does it come from?

What controls are in place to ensure that the obtained information is accurate and complete?

Should more than one category be used to disaggregate?

Is information reconciled to segment disclosures?

Consider information in segment disclosure, in MD&A, presented in earnings releases and investor calls, and reviewed by the CODM.
Connecting the Dots — Tabular Reconciliation of Disaggregated Revenue

The disclosure of disaggregated revenue does not need to be in any particular format and may be presented in a tabular format or a narrative format.

At the November 2016 TRG meeting, in response to a question about the form of this disclosure, the FASB staff indicated that a tabular reconciliation (such as that of Example 41 in ASC 606-10-55-296 and 55-297) is not required. However, the staff also noted that an entity must still provide the information required under ASC 606-10-50-6 (i.e., information that enables users to understand the relationship between the disclosure of disaggregated revenue and revenue disclosed for each reportable segment). A summary of the TRG’s discussion is available in TRG Agenda Paper 60.

15.2.2 Contract Balances

The table below summarizes the disclosure requirements discussed in this section through Section 15.2.2.5.2, including the disclosures that a nonpublic entity may elect not to apply as well as required interim disclosures.

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract balances</td>
<td>Opening and closing balances (receivables, contract assets, and contract liabilities).</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Amount of revenue recognized from beginning contract liability balance.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Explanation of significant changes in contract balances (using qualitative and quantitative information).</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Many entities under legacy 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).
Questions that entities could consider in preparing these disclosures (and others) include, but are not limited to, the following:

- On reassessment of disclosures already presented in the financial statements, are those disclosures sufficient?
- What controls are in place to test the completeness and accuracy of the information disclosed?
- Is the legacy 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 relevant 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:

- The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
- Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
- Subparagraph superseded by Accounting Standards Update No. 2016-20.

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.
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).

### 15.2.2.1 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.

### 15.2.2.2 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.

### 15.2.2.3 Election Available to Nonpublic Entities

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 and 606-10-50-12A. However, if an entity elects not to provide the disclosures in paragraphs 606-10-50-8 through 50-10 and 606-10-50-12A, 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.
15.2.2.4 Disclosure Examples

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.

| 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)

The illustrative disclosure below shows how an entity might provide the information required under ASC 606-10-50-8 through 50-10.
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 professional 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, typically no longer than one year. 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 customer payment or receivable in connection with estimates of variable consideration) or a contract liability (customer payment or receivable 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 customer payment or receivable. Contracts with payment in arrears are recognized as receivables (including any long-term receivables) after the Company considers whether a significant financing component exists and, in some cases, adjusts for a significant financing component.

The opening and closing balances of the Company’s contract asset, current and long-term contract liability, and receivables are as follows:

<table>
<thead>
<tr>
<th>Contract Balances (Current)</th>
<th>Receivables</th>
<th>Contract Asset</th>
<th>Contract Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening (1/1/20X8)</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Closing (12/31/20X8)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Increase/(decrease)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Opening (1/1/20X7)</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Closing (12/31/20X7)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Increase/(decrease)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Opening (1/1/20X6)</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Closing (12/31/20X6)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Increase/(decrease)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
</tbody>
</table>
### Illustrative Disclosure — Contract Balances (continued)

<table>
<thead>
<tr>
<th>Contract Balances (Long-Term)</th>
<th>Receivables</th>
<th>Contract Asset</th>
<th>Contract Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening (1/1/20X8)</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Closing (12/31/20X8)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Increase/(decrease)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Opening (1/1/20X7)</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Closing (12/31/20X7)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Increase/(decrease)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Opening (1/1/20X6)</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Closing (12/31/20X6)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Increase/(decrease)</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
</tbody>
</table>

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.

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.

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.
15.2.2.5 Additional Considerations

15.2.2.5.1 Rollforward of Contract Balances

Under ASC 606, an entity is required to present or disclose opening and closing contract balances in its annual and interim financial statements. In addition, an entity is required under ASC 606-10-50-8(b) to disclose revenue recognized from the prior year-end contract liability balance. However, an entity does not need to provide a full rollforward of the information required under ASC 606-10-50-8(b) about revenue recognized from the prior year-end contract liability balance.

Paragraph BC346 of ASU 2014-09 states, in part:

[The FASB and IASB] decided that, instead of requiring a tabular reconciliation of the aggregate contract balances [as they had proposed in their 2010 and 2011 exposure drafts on revenue], they would require an entity to disclose qualitative and quantitative information about the entity's contract balances (see paragraphs 606-10-50-8 through 50-10). This approach balances the needs of users of financial statements with preparers' concerns because the qualitative and quantitative disclosures provide users of financial statements with the information they requested (that is, 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, the Boards decided that those disclosures would be more cost-effective than a reconciliation. The Boards also observed that this approach would not result in a significant change for many entities that are already disclosing similar information.

Accordingly, a rollforward of contract balances is not required because the FASB decided that in a manner consistent with paragraph BC346 of ASU 2014-09, entities should be given some flexibility to determine how to present contract balances and changes in those balances.

However, at the November 2016 TRG meeting, the FASB staff noted that although a full rollforward is not required, an entity may elect to present the disclosures related to contract balances in the form of a full rollforward. Further, when doing so, an entity may:

- Present such information on a quarterly basis to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, which is the disclosure objective stated in the new revenue standard.
- Provide a gross figure that includes revenue recognized (1) from the prior recorded contract liability balance and (2) that flowed in and out of the balance in the same period (i.e., the typical line item [deduction] that would be present in a full rollforward of the contract liability balance).
- Include a quarterly rollforward of each quarter separately, but omit a year-to-date rollforward. For example, a calendar-year-end public company reporting its second-quarter financial information may provide a rollforward of the three months ended March 31 and a separate rollforward of the three months ended June 30, but may forgo providing a rollforward of the six months ended June 30.

15.2.2.5.2 Contract Liability Balance Disclosures

An entity should present certain liabilities, such as refund liabilities, separately from contract liabilities (see Section 14.3 for a discussion about the need to present refund liabilities separately from contract liabilities). These liabilities may commonly arise when an entity sells products with a right of return and the entity expects that a certain quantity of those products will be returned (see Sections 6.3.5.2 and 6.3.5.3). These liabilities may also arise when an entity receives cash in advance, but the agreement is cancelable because of certain termination provisions in the agreement (see Section 4.4.1).

In December 2016, the FASB issued ASU 2016-20, which clarified (by moving the content previously in ASC 606-10-50-8(c) to ASC 606-10-50-12A) 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 corresponding contract balances.”

For more information about the November 7, 2016, TRG meeting, see TRG Agenda Paper 60 and Deloitte's November 2016 TRG Snapshot.
Assume that an entity chooses to present a full rollforward of its contract liability. Further assume that (1) some of the entity’s arrangements contain termination provisions and (2) amounts received by the entity that are related to such contracts have been recorded as a liability separate from the contract liability. The entity would not be permitted to include the separate liability in its contract liability balance disclosures required by ASC 606-10-50-8. However, one approach may be to reclassify the separate liability as a contract liability when, for example, the contract is no longer cancelable without penalty and the amounts are recharacterized as deferred revenue. The illustrative disclosure below demonstrates the contract liability rollforward approach for entities that elect such presentation related to their separate liabilities.

**Illustrative Disclosure — Contract Liability Balance Rollforward**

Changes in the contract liability balance were as follows for the years ended December 31, 20X8, and December 31, 20X7:

<table>
<thead>
<tr>
<th></th>
<th>December 31, 20X8</th>
<th>December 31, 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, beginning of period</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Deferral of revenue[*)</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Reclassification of separate</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>liabilities (e.g., refund liability)</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Recognition of unearned revenue[**]</td>
<td>(XX)</td>
<td>(XX)</td>
</tr>
<tr>
<td>Balance, end of period</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
</tbody>
</table>

* Represents consideration received from a customer, or an unconditional right to consideration (i.e., a receivable), that is related to goods or services to be transferred to the customer in the future.

** Represents previously recognized contract liabilities for which the entity has transferred the related goods or services to the customer and recognized the related revenue in the current period.
15.2.3 Performance Obligations

The table below summarizes the disclosure requirements discussed in this section through Section 15.2.3.3.2, including the disclosures that a nonpublic entity may elect not to apply as well as required interim disclosures.

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance obligations (including remaining performance obligations)</td>
<td>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.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Transaction price allocated to the remaining performance obligations:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Disclosure of quantitative amounts.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>• Quantitative or qualitative explanation of when remaining performance obligation amounts will be recognized as revenue.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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 (e.g., because of return or refund rights)? 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?
• Does the entity offer warranties? If so, are they assurance-type warranties or promised services?

**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.

**50-12A** An entity shall disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

**15.2.3.1 Nature of Performance 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.

What are the distinct promises in your contracts? When are they typically satisfied?

Have all performance obligations been disclosed? Consider any material rights or warranty obligations.
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.

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.

15.2.3.2 Disclosure of Revenue Recognized From Past Performance

In accordance with ASC 606-10-50-12A, 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 606-10-50-12A.

Example 15-1

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).
Example 15-1 (continued)

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.

In accordance with ASC 606-10-50-12A, this $500 cumulative catch-up adjustment should be disclosed. The entity may make this disclosure as follows:

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Original</th>
<th>Adjusted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed component</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Variable component</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Total potential transaction price</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Contract inception transaction price</td>
<td>3,000</td>
<td></td>
</tr>
</tbody>
</table>

![Table]

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.”

15.2.3.3 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.

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.
For example, suppose that a calendar-year-end entity sells a two-year noncancelable 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).

Since determining when performance obligations are satisfied is a matter of judgment, as discussed above and in Section 15.3, the required disclosures related to remaining performance obligations may be subjective and difficult to determine. In light of this, entities could 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 15.2.3.3.1.)
- Has the entity recognized revenue as invoiced in accordance with ASC 606-10-55-18? (See Section 15.2.3.3.1.)
- Has the entity recognized sales- or usage-based royalties in exchange for a license of intellectual property (IP) in accordance with ASC 606-10-55-65 through 55-65B? (See Section 15.2.3.3.1.)
- Has the entity allocated variable consideration entirely to a wholly unsatisfied performance obligation or distinct good or service that forms part of a series in accordance with ASC 606-10-32-40? (See Section 15.2.3.3.1.)
- 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 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 already implemented and operating effectively.)
Connecting the Dots — SEC Backlog Disclosure Versus ASC 606 Remaining Performance Obligation Disclosure

On August 26, 2020, the SEC issued a final rule that modernizes the disclosure requirements in SEC Regulation S-K, Items 101, 103, and 105. For more information about this final rule, see Deloitte’s September 3, 2020, Heads Up.

Before the amendments in the final rule, Item 101(c) required an SEC registrant’s description of the business to focus on its reportable segments. Item 101(c) listed 12 items, including the “dollar amount of backlog orders believed to be firm,” that had to be included in the registrant’s disclosures if material. In adopting the final rule, the SEC noted that the prescriptive list of “disclosure requirements may elicit disclosure that is not material to a particular registrant” and that the amendments are intended to reinforce a principles-based approach. The final rule provides a revised nonexclusive list of disclosures topics, including information about “revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, services, product families or customers.” Disclosure is required if the topics are “material to an understanding of the registrant’s business taken as a whole.” While “backlog” is no longer explicitly identified or defined, registrants should consider whether backlog disclosures are material in accordance with the principles-based approach outlined in the final rule.

Depending on the nature of the contracts common in an industry, or specific facts and circumstances for each entity, the backlog disclosure as presented in accordance with Item 101(c) before adoption of the final rule may not be consistent with the remaining performance obligation disclosure required by ASC 606.

The ASC 606 disclosure requirement represents the transaction price allocated to the unsatisfied or partially unsatisfied performance obligations at the end of the reporting period and comparative period. This ASC 606 disclosure is not required when the performance obligation is part of a contract whose original expected duration is one year or less. This could be the case for a cancelable contract with a stated term of more than one year, as shown in Example 15-2. If an entity determines that the same cancelable contract in Example 15-2 constitutes a “firm” order for purposes of the SEC's backlog disclosure requirement under Item 101(c) before adoption of the final rule, the amounts disclosed for the contract in accordance with the ASC 606 remaining performance obligation disclosure requirement may differ from those disclosed in accordance with the SEC backlog disclosure. In addition, the guidance in ASC 606 that allows entities to elect not to disclose information about remaining performance obligations in certain contracts that meet specific requirements (see Section 15.2.3.3.1) may lead to additional differences between the ASC 606 remaining performance obligation disclosure and the SEC backlog disclosure defined in Item 101(c) before adoption of the final rule. To the extent that the amounts in the SEC backlog disclosure differ from those in the ASC 606 remaining performance obligation disclosure, an SEC registrant may be required to provide in its description of its business the SEC backlog disclosure rather than a cross-reference to the financial statements’ ASC 606 remaining performance obligation disclosure. However, after adoption of the final rule, registrants should consider whether backlog disclosures are material and, if so, whether the ASC 606 remaining performance obligation disclosure would provide sufficient information for investors.

For additional information about SEC backlog disclosures, see Section 3.9.4 of Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights.
15.2.3.3.1 Election Not to Provide Certain Disclosures

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, an election under ASC 606-10-50-14 or 50-14A is available to all entities for contracts in any of the following circumstances:

- 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 8.5.8.1).
- The contract provides for variable consideration constituting a sales- or usage-based royalty promised in exchange for a license of IP that is accounted for in accordance with ASC 606-10-55-65 through 55-65B (see Section 12.7).
- Certain instances in which the guidance in ASC 606-10-32-40 is applied (see Section 7.5.4).

ASC 606-10

50-14 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.

50-14A An entity need not disclose the information in paragraph 606-10-50-13 for variable consideration for 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.

50-14B The optional exemptions in paragraphs 606-10-50-14(b) and 606-10-50-14A shall not be applied to fixed consideration.

50-15 An entity shall disclose which optional exemptions in paragraphs 606-10-50-14 through 50-14A it is applying. In addition, an entity applying the optional exemptions 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 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.
As noted in ASC 606-10-50-14B above, if an entity elects to use the optional exemptions from the requirement to disclose the information described in ASC 606-10-50-13, the entity would still need to disclose the amount of fixed consideration allocated to outstanding performance obligations. That is, the entity would still need to disclose the amount of consideration allocated to outstanding performance obligations that is not contingent on the resolution of an uncertainty (i.e., not variable consideration).

Example 15-2 below illustrates a situation in which an entity would not be required to disclose information about its remaining performance obligations because the contract is cancelable within one year or less without substantive penalty.

**Example 15-2**

Company A enters into a two-year term license agreement to provide a right-to-use license of IP and postcontract customer support (PCS) during the contract term to Customer B in exchange for a fixed fee of $2,400, which is prepaid by B at contract inception. Customer B can terminate the contract for convenience at any time after the first month in exchange for a pro rata refund of its prepaid consideration. For example, if B terminates the agreement at the beginning of month 2, B would no longer be able to use the IP but would receive a refund of $2,300. As a result of the cancellation provision, the contract would be accounted for as a one-month term license (and PCS) with optional daily renewals. See [Section 12.3.4](#).

Company A is not required to disclose information about its remaining performance obligations in its contract with B in accordance with the disclosure requirement in ASC 606-10-50-13. This is because ASC 606-10-50-14 states that an entity does not need to disclose information about its remaining performance obligations (as required under ASC 606-10-50-13) if the performance obligation is part of a contract that has an original expected duration of one year or less.

Although A’s contract with B has a stated contract term of two years, only the first month is legally enforceable because of B’s ability to terminate the contract for convenience after one month with no penalty. Therefore, for purposes of applying the guidance and disclosure requirements in ASC 606, the contract term is only one month. If the election is not made, the remaining performance obligation that could be included in the disclosure would be limited to the remaining portion of the one-month obligation to provide PCS.

In addition, because $2,300 of the up-front consideration received from B is related to potential contract renewals that are, in effect, optional purchases (i.e., consideration for months 2 through 24), that amount should be presented as a deposit liability (or similar liability) rather than a contract liability. That is, the $2,300 does not represent A’s obligation to transfer goods or services to a customer for which the entity has received consideration (or for which the amount is due) from the customer. This is because A is not obligated to transfer additional term licenses and PCS to the customer until the customer exercises its option to renew the contract after one month (by electing not to terminate the contract).

This presentation and the disclosure requirements would be the same for other contracts that include cancellation provisions with no substantive termination penalties (e.g., a contract to provide two years of consulting services or SaaS for $2,400 that is cancelable after the first month without a substantive penalty).

### 15.2.3.3.2 Illustrative Examples

The Codification examples below 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.
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, the entity could elect to apply the optional exemption in paragraph 606-10-50-14(b). If the entity elects not to disclose the transaction price allocated to remaining performance obligations for Contract A, the entity would disclose that it has applied the optional exemption in paragraph 606-10-50-14(b). The entity also would disclose the nature of the performance obligation, the remaining duration, and a description of the variable consideration that has been excluded from the disclosure of remaining performance obligations in accordance with paragraph 606-10-50-15.

**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.

<table>
<thead>
<tr>
<th></th>
<th>20X8</th>
<th>20X9</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue expected to be recognized on this contract as of December 31, 20X7</td>
<td>$ 4,800(a)</td>
<td>$ 2,400(b)</td>
<td>$ 7,200</td>
</tr>
</tbody>
</table>

(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.
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.

<table>
<thead>
<tr>
<th>Revenue expected to be recognized on this contract as of December 31, 20X7</th>
<th>20X8</th>
<th>20X9</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Transaction price = $3,150 ($100 × 24 months + $750 variable consideration) recognized evenly over 24 months at $1,575 per year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) $1,575 ÷ 2 = $788 (that is, for 6 months of the year)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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 entity does not meet the criteria to apply the optional exemption in paragraph 606-10-50-14A because the monthly consideration is fixed and the variable consideration does not meet the condition in paragraph 606-10-50-14A(b).

Example 43 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations — Qualitative Disclosure

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.

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.

The illustrative disclosure below further demonstrates how an entity may provide a quantitative disclosure of the transaction price to be allocated to the remaining performance obligations.\(^{11} \)

---

\(^{11}\) This illustrative disclosure includes the optional exemptions applied in ASC 606-10-50-14 and 50-14A. In addition to disclosing the optional exemptions applied, an entity should disclose the qualitative information required in ASC 606-10-50-15.
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.

<table>
<thead>
<tr>
<th>Remaining Performance Obligations</th>
<th>20X8</th>
<th>20X9</th>
<th>20Y0</th>
<th>20Y1</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue expected to be recognized on multiyear Type A contracts in place as of December 31, 20X7</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Revenue expected to be recognized on multiyear Type B contracts in place as of December 31, 20X7</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Revenue expected to be recognized on multiyear Type C contracts in place as of December 31, 20X7</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
</tbody>
</table>

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.
### 15.3 Significant Judgments

The table below summarizes the disclosure requirements discussed in this section through Section 15.3.2, including the disclosures that a nonpublic entity may elect not to apply as well as required interim disclosures.

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant judgments and estimates</td>
<td>Qualitative information about determining the timing of:</td>
<td>Yes(^{12})</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Yes (^{13})</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Performance obligations satisfied at a point in time — specifically, the significant judgments used in the evaluation of when a customer obtains control.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Qualitative and quantitative information(^{13}) about:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration).</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Constraining estimates of variable consideration.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Measuring obligations for returns, refunds, and other similar obligations.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

\(^{12}\) See footnote 6.

\(^{13}\) See footnote 7.
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 its accounting policies as well as the assumptions and methods used. The new revenue standard significantly expands legacy disclosure requirements related to judgments associated with revenue recognition. Questions that entities could consider in implementing the new requirements include the following:

- Are all significant judgments and estimates related to variable consideration, significant financing components, 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.

### 15.3.1 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. |
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.

Illustrative Disclosure — Performance Obligations Satisfied Over Time

Approximately 60 percent of Company A’s revenue is for performance obligations related to long-term stand-ready 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 a cost-based input method (i.e., Type Y services), the progress toward completion is measured on the basis of the labor costs related to employees of differing experience levels that provide the professional services. Using a cost-based input appropriately takes into account both the number of hours incurred by each employee and the value of each labor hour provided to the customer. For performance obligations recognized in accordance with the other output methods (i.e., Type Z services), the best measure of depicting the Company’s performance as control is transferred is typically hours. For example, for Type Y services, the customer obtains equal value as each increment of labor hours is provided.
Illustrative Disclosure — Performance Obligations Satisfied at a Point in Time

For performance obligations related to Type A products, the Company determines that the customer obtains control of 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 because those products are shipped “free on board” destination. The Company’s standard delivery method for all other products 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.

15.3.2 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: . . .

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.

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 related to volume-based rebates given to larger customers.

The Company estimates variable consideration and performs a constraint analysis for these contracts on the basis of both historical information and current trends to estimate the amount of cash discounts or rebates to which customers are likely to be entitled.

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 makes payments in arrears for equipment purchases. Contracts that management determines to include a significant financing component are discounted on the basis of the customer's credit characteristics and collateral associated with the equipment. The Company recognizes interest income and accretes the receivable over the financing term.
15.4 Contract Costs

The table below summarizes the disclosure requirements discussed in this section, including the disclosures that a nonpublic entity may elect not to apply as well as required interim disclosures.

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract costs</td>
<td>Qualitative information about:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Judgments the entity made in determining the amount of the costs incurred to obtain or fulfill a contract.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• The method the entity uses to determine the amortization for each reporting period.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Quantitative information about:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>• The amount of amortization and any impairment losses recognized in the reporting period.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Entities are 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.

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 information required under ASC 340-40-50-1.

### Illustrative Disclosure — Qualitative and Quantitative Information About Contract Costs

**Assets Recognized From the Costs Incurred to Obtain or Fulfill a Contract With a Customer**

For business units C and D, the incentive portions of the Company's sales commission plans qualify for capitalization since these payments are directly related to sales achieved during a time period. The amortization period for the capitalized asset is the original contract term because commensurate commissions are paid for all renewals. For these capitalized sales commissions, the Company amortizes the capitalized costs and allocates them on a relative basis to the products and services sold. When the Company recognizes revenue related to goods and services over time by using the time-elapsed output method, the commission costs related to those goods and services are amortized ratably 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.

For business unit A, the incentive portions of the Company's 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 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.

None of the Company's fulfillment costs incurred meet the capitalization criteria for costs of fulfilling a contract because they do not generate or enhance resources used to satisfy promises to provide future goods or services.

### 15.5 Disclosure of Practical Expedients Used

The table below summarizes the disclosure requirements discussed in this section, including the disclosures that a nonpublic entity may elect not to apply as well as required interim disclosures.

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure Requirements</th>
<th>Election Available to Nonpublic Entities</th>
<th>Interim Requirement (ASC 270)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Practical expedients</td>
<td>Disclosure of practical expedients used.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

A number of practical expedients are available to both public business entities (PBEs) 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), (2) contract costs (as discussed further in Chapter 13), and (3) disclosures for remaining performance obligations (as discussed further in Section 15.2.3.3.1).
Further, the amendments in **ASU 2016-10** and **ASU 2016-12** include four 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 promised good or service 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 5.2.4.3** 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 6.7** 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.
• **Full retrospective approach** — ASU 2016-12 provides a practical expedient for entities that elect to use the full retrospective transition method. Entities are required to disclose the method and practical expedients used in transition. Refer to Section 16.2.1 for further information.

• **Modified retrospective approach** — ASU 2016-12 provides a practical expedient for entities that elect to use the modified retrospective transition method. As previously noted, entities are required to disclose the method and practical expedients used in transition. Refer to Section 16.2.2 for further information.

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 disclosure below shows how an entity may disclose that management has elected certain practical expedients available under the new revenue standard.

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**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 when the Company expects to recognize this revenue.

For the Company’s three-year Service X contracts, the Company invoices a fixed amount for each hour of service and recognizes revenue based on the amount it has a right to invoice as a practical expedient. Therefore, the Company has elected not to disclose (1) the transaction price for the remaining performance obligations associated with Service X as of the end of each reporting period or (2) when the remaining revenue related to these contracts will be recognized.

The illustrative disclosure below shows how an entity may describe its use of the practical expedient related to contract 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 product A, product B, and service C, the practical expedient is elected because the amortization period would be 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 (i.e., 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.

15.6 Interim Disclosure Requirements in the Year of Adoption

In each of the interim periods in the year of adoption of the new revenue standard, an SEC registrant is required to disclose information in addition to the disclosures required under ASC 250 and ASC 270 and the transitional disclosures required under ASC 606-10-65.

SEC Regulation S-X, Rule 10-01(a)(5), states, in part:

Registrants may presume that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year and that the adequacy of additional disclosure needed for a fair presentation may be determined in that context. Accordingly, footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual report to security holders or latest audited financial statements, such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year, and detailed disclosures prescribed by [SEC Regulation S-X, Rule 4-08,] may be omitted.

In addition, Section 1500 of the SEC Division of Corporation Finance’s Financial Reporting Manual (FRM) provides the following guidance on interim-period financial statement disclosures upon adoption of a new accounting standard:

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.
In accordance with the guidance above, an SEC registrant is required to provide the annual disclosures prescribed in ASC 606-10-50 to the extent that they are not duplicative of the interim disclosures. This requirement is consistent with the views expressed by the SEC staff at the March 2001 AICPA SEC Regulations Committee joint meeting with the SEC staff, including the following (as summarized in the highlights of the meeting):

Regulation S-X, Article 10-01(a)(5), requires disclosure in an interim period of new accounting principles and practices, details in accounts that have changed significantly in amount or composition, and other significant changes that have occurred since the end of the most recently completed fiscal year. When a new standard is adopted in an interim period, the staff has interpreted this requirement to mean that all disclosures prescribed by the standard should be included in the interim financial statements, in addition to any transitional disclosures required by the standard.

Further, as Section 1500 of the FRM indicates, “[t]hese disclosures should be included in each quarterly report in the year of adoption” rather than only in the first interim period. This requirement is consistent with comments expressed by the SEC staff at the March 2002 AICPA SEC Regulations Committee joint meeting with the SEC staff. Specifically, as noted in the highlights of the meeting, the SEC staff supported the following view:

Regulation S-X does not presume that users of interim financial information have read prior interim reports and so therefore it is not appropriate to rely on disclosures made in prior interim reports. Furthermore, even though disclosures have been made in prior interim reports, they would be considered to be stale from a ’33 Act reporting perspective and would have to be freshened. Accordingly, it is appropriate to require that they be kept current even if there is no ’33 Act registration statement pending or contemplated prior to year end.

Information about the annual disclosures required under ASC 606-10-50 is provided throughout this chapter of the Roadmap.
Chapter 16 — Effective Date and Transition Requirements

16.1 Effective Date

16.1.1 Effective Date for Emerging Growth Companies

16.1.2 Effective-Date Relief for Certain Public Business Entities

16.2 Transition

16.2.1 Full Retrospective Method

16.2.2 Modified Retrospective Method

16.2.3 Determining Which Transition Method to Apply

16.2.4 Contract Assets and Contract Liabilities Under the Full Retrospective and Modified Retrospective Transition Methods

16.2.5 Transition and Scope Considerations for Lessors

16.1 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 that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, shall apply the [guidance in the new revenue standard] for annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020. 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 (e.g., public business entities (PBEs)) was annual reporting periods beginning after December 15, 2016 (the “original PBE adoption date”); all other entities could adopt the new revenue standard as of the original PBE 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.

In June 2020, the FASB issued ASU 2020-05, which permits private entities (i.e., entities other than those listed in ASC 606-10-65-1(a)) that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, to adopt ASC 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. Since the deferral is not mandatory, private entities may still elect to adopt ASC 606 in accordance with previous guidance (i.e., for annual reporting periods beginning after December 15, 2018, and for interim reporting periods within annual reporting periods beginning after December 15, 2019). In addition, private entities that have issued their financial statements or made financial statements available for issuance on or before June 3, 2020, would have had to adopt ASC 606 in accordance with previous guidance.

These amendments to ASU 2014-09 have been reflected in the guidance above.

16.1.1 Effective Date for Emerging Growth Companies

As discussed in paragraph 11110.2 of the FRM, an emerging growth company (EGC)¹ may elect to adopt the new revenue standard as of the effective date applicable to nonissuers (as opposed to the effective date applicable to PBEs). If it makes this election, the EGC would not need to update the supplemental quarterly financial data in its annual report until nonissuers are required to apply the standard to interim periods (e.g., calendar years beginning on January 1, 2020 [or calendar years beginning on January 1, 2021, if financial statements were not issued or made available for issuance as of June 3, 2020²]).

Private entities that have issued their financial statements or made financial statements available for issuance on or before June 3, 2020, and subsequently become an EGC would have to adopt ASC 606 in accordance with previous guidance and would be required to apply the standard to interim periods for calendar years beginning on January 1, 2020.

16.1.2 Effective-Date Relief for Certain Public Business Entities

At the July 20, 2017, meeting of the EITF, and in response to concerns expressed by accountants, SEC registrants, and other stakeholders, the SEC staff provided significant relief to registrants that are required to include financial statements or financial information of other reporting entities in their SEC filings. Specifically, the SEC staff announced that it would not object to elections by certain PBEs to use the non-PBE effective dates for the sole purpose of adopting certain new standards, including ASC 606.³

The staff announcement makes clear that the ability to use non-PBE effective dates for adopting the new revenue and leasing standards is limited to the subset of PBEs “that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity’s filing with the SEC.” The principal beneficiaries of the relief will be SEC filers that include financial statements or financial information prepared by specified PBEs in their own filings (e.g., an SEC filer that includes financial statements of an acquiree in a business combination or accumulation of equity method investments).

¹ For a discussion of the qualifications for EGC status and the accommodations applicable to EGCs, see Section 1.6 of Deloitte’s A Roadmap to Initial Public Offerings.

² The situations in which an EGC has not issued or made available for issuance its financial statements by June 3, 2020, are expected to be limited to when the entity is a new EGC registrant.

³ The announcement was applicable to ASC 606 and ASC 842 only.
The ASC master glossary defines a PBE, in part, as a business entity that is “required by the [SEC] to file or furnish financial statements, or [that] 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)” (emphasis added). The definition further states that 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.”

**Example 16-1**

Company A, a publicly traded manufacturer, holds equity method investments in three of its nonpublic suppliers. On the basis of applying the SEC Regulation S-X significance tests, A has determined that it must include summarized financial information for Suppliers X, Y, and Z (under Regulation S-X, Rule 4-08(g)) in its SEC filing. Suppliers X, Y, and Z meet the definition of a PBE only because of the required inclusion of their financial information in A’s SEC filing. Consequently, X, Y, and Z plan to use the non-PBE adoption dates of ASC 606 for their own stand-alone financial statement preparation purposes. When including the summarized financial information of X, Y, and Z in its own SEC filing, A is not required to adjust the suppliers’ financial statements to reflect the PBE adoption date of ASC 606.

In September 2017, the FASB issued ASU 2017-13, which amends certain SEC guidance in the Codification to reflect the SEC staff announcement issued at the July 20, 2017, EITF meeting and the rescission of prior SEC staff announcements and observer comments. Specifically, ASU 2017-13 adds ASC 606-10-S65-1 to codify the SEC staff announcement regarding the ability for certain PBEs to use the non-PBE effective date when adopting the new revenue standard and new leasing standard. For additional information on ASU 2017-13, see Sections 20.2.2.5 and 20.3.3.7.

### 16.2 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)].

The full retrospective transition method (see Section 16.2.1) requires retrospective application of the new guidance to each prior reporting period presented. The modified retrospective method (see Section 16.2.2) allows entities to apply the new revenue standard through a cumulative-effect adjustment as of the date of adoption (1) to all contracts or (2) only to contracts that are not completed as of the date of initial application.
ASC 606-10-65-1(c), as amended by ASU 2016-12,4 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).

16.2.1 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 method 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.

4 The IASB did not make similar amendments to IFRS 15. Refer to Appendix A for more information about differences between U.S. GAAP and IFRS Standards.
Under ASC 606-10-65-1(g), any practical expedients used should be applied consistently to all contracts within all reporting periods presented.

16.2.1.1 Contract Modification Practical Expedient

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.

16.2.1.2 Disclosure Requirements

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**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-1</td>
<td>An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:</td>
</tr>
<tr>
<td>a.</td>
<td>The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.</td>
</tr>
<tr>
<td>b.</td>
<td>The method of applying the change, including all of the following:</td>
</tr>
<tr>
<td>1.</td>
<td>A description of the prior-period information that has been retrospectively adjusted, if any.</td>
</tr>
<tr>
<td>2.</td>
<td>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. 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.</td>
</tr>
<tr>
<td>3.</td>
<td>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.</td>
</tr>
<tr>
<td>4.</td>
<td>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).</td>
</tr>
<tr>
<td>c.</td>
<td>If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:</td>
</tr>
<tr>
<td>1.</td>
<td>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.</td>
</tr>
<tr>
<td>2.</td>
<td>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.</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-2</td>
<td>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.</td>
</tr>
</tbody>
</table>

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 16.2.2.

### 16.2.1.3 Five-Year Table Required Under SEC Regulation S-K, Item 301, for SEC Registrants

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

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5 Reference to “the current period” removed because of the guidance in ASC 606-10-65-1(e).
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 20 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.

16.2.2 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)].

16.2.2.1 Determining Whether a Contract Is Completed at Transition

As noted above, 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.

ASC 606-10-65-1(c)(2) states that 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.”
Example 16-2 illustrates common situations of how an entity would determine whether a contract is completed as of the adoption date.

**Example 16-2**

An entity that is a PBE adopts the guidance in ASC 606 on January 1, 2018, and elects to apply the modified retrospective method to only 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).

For each situation, assume the same facts outlined above.

**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 the entity would have recognized (after considering whether a significant financing component exists) 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 16-2 (continued)

Under ASC 606, revenue from this arrangement would be recognized at the point in time when 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, 2017.

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. As a result, this contract would not be adjusted for the impact of applying the revenue model in accordance with ASC 606.

Note that in this situation, the accounting treatment upon transition would be different if the entity elected to apply the modified retrospective method to all contracts. Refer to Example 16-3 for discussion of applying the modified retrospective method to all contracts.

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 of the product 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. As a result, this contract would not be adjusted for the impact of applying the revenue model in accordance with ASC 606.

Note that in this situation, the accounting treatment upon transition would be different if the entity elected to apply the modified retrospective method to all contracts. Refer to Example 16-3 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. 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 Section 20.3.3.5.

Example 16-3 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.

**Example 16-3**

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 from the entity. 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.

**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.

**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 revenue related to the loyalty points that was previously recognized under legacy revenue guidance 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.

**Connecting the Dots — 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 methods 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).

### 16.2.2.2 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 16-4**

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 in accordance with A's policy 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.
Example 16-4 (continued)

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.

16.2.2.3 Disclosures Upon Application of the Modified Retrospective Method of 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)].

On the other hand, 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, as indicated above, 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 in the period of adoption so that they can provide the disclosures.

16.2.3 Determining Which Transition Method 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 in the period of adoption so that it can provide the disclosures. In addition, these
requirements are for both annual and interim periods; therefore, PBEs 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 and comparability 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 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:

<table>
<thead>
<tr>
<th>Method</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full retrospective method</td>
<td>• Comparative numbers for all years presented minimize any disruption in trends.</td>
<td>• Using the full retrospective method may require significant implementation efforts depending on impact.</td>
</tr>
<tr>
<td></td>
<td>• Practical expedients provide the following relief:</td>
<td>• Information needed to determine the transition's impact may not be readily available.</td>
</tr>
<tr>
<td></td>
<td>◦ Contracts that begin and end in the same annual reporting period do not need to be restated.</td>
<td>• 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 Section 20.2.2.2 for additional discussion.</td>
</tr>
<tr>
<td></td>
<td>• Hindsight can be used to determine the transaction price.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The method gives entities an opportunity to perform “trial runs” to address potential unforeseen/unplanned challenges related to the transition.</td>
<td></td>
</tr>
<tr>
<td>Modified retrospective method</td>
<td>• Entities will have more time to (1) define or establish policies and (2) design and implement changes to processes.</td>
<td>• Financial statement trends may be disrupted, and stakeholders may request supplemental information.</td>
</tr>
<tr>
<td></td>
<td>• The method provides relief from restating and presenting comparable prior-year financial statements.</td>
<td>• Meeting the requirement to disclose the amount by which each financial statement line item is affected by the new revenue guidance in the period of adoption 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 the period of adoption.</td>
</tr>
<tr>
<td></td>
<td>• Contracts completed before the transition date do not need to be evaluated under the new revenue standard.</td>
<td></td>
</tr>
</tbody>
</table>

The selected adoption method 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 method 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.
### 16.2.4 Contract Assets and Contract Liabilities Under the Full Retrospective and Modified Retrospective Transition Methods

The example below illustrates the accounting for a newly created contract asset upon adoption of the new revenue standard under both the full retrospective and modified retrospective transition methods.

#### Example 16-5

On January 1, 2015, Company A, a public company with a calendar year-end, enters into a contract to provide a product and five years of maintenance services to a customer. Title to the product is transferred to the customer upon shipment on January 1, 2015, and the maintenance services will be performed evenly from January 1, 2015, through December 31, 2019. In exchange for the product and the maintenance services, the customer pays A the following amounts:

<table>
<thead>
<tr>
<th>Item</th>
<th>Contract Price</th>
<th>Payment Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product</td>
<td>$750</td>
<td>Contract inception</td>
</tr>
<tr>
<td>Maintenance services</td>
<td>$1,500 ($300 per year)</td>
<td>Annually at the end of each year beginning December 31, 2015</td>
</tr>
<tr>
<td>Total</td>
<td>$2,250</td>
<td></td>
</tr>
</tbody>
</table>

The table below shows the stand-alone selling prices (SSPs), allocation percentages, and amounts of the total transaction price (TTP) allocated for the product and the maintenance services, respectively.

<table>
<thead>
<tr>
<th>Item</th>
<th>SSP</th>
<th>Allocation Percentage</th>
<th>Amount of TTP Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product</td>
<td>$1,000</td>
<td>40% ($1,000 ÷ $2,500)</td>
<td>$900 ($2,250 × 40%)</td>
</tr>
<tr>
<td>Maintenance services</td>
<td>$1,500 ($300 per year)</td>
<td>60% ($1,500 ÷ $2,500)</td>
<td>$1,350 ($2,250 × 60%)</td>
</tr>
<tr>
<td>Total</td>
<td>$2,500</td>
<td>100%</td>
<td>$2,250</td>
</tr>
</tbody>
</table>

Under legacy U.S. GAAP (specifically, ASC 605-25), A concludes that the product and maintenance services are separate units of accounting. In addition, A’s revenue under legacy U.S. GAAP is limited to the amount that is not contingent on future events. Therefore, although the amount allocated to the product on the basis of its relative selling price is $900, A may not recognize more than the $750 received for the product at contract inception because that is the amount that is not contingent on future events (i.e., the delivery of the maintenance services). Consequently, A records the journal entries below in accordance with legacy U.S. GAAP.

**On January 1, 2015 (contract inception), to recognize revenue upon shipment of the product:**

- **Cash** 750
- **Revenue** 750

**On December 31, 2015, to recognize revenue for the first year of maintenance services:**

- **Cash** 300
- **Revenue** 300

**On December 31, 2016, to recognize revenue for the second year of maintenance services:**

- **Cash** 300
- **Revenue** 300
Example 16-5 (continued)

On December 31, 2017, to recognize revenue for the third year of maintenance services:

Cash 300
Revenue 300

As of December 31, 2017, A has recognized $1,650 of revenue (i.e., $750 of product revenue and three years of maintenance services at $300 per year). The table below summarizes A’s balance sheet and income statement presentation for the years ended December 31 of 2015, 2016, and 2017, respectively (assume that this is A’s only contract):

<table>
<thead>
<tr>
<th></th>
<th>Year Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015</td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,050</td>
</tr>
<tr>
<td>Retained earnings*</td>
<td>1,050</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>1,050</td>
</tr>
</tbody>
</table>

* For simplicity, this example assumes that A did not incur any costs to provide the product and the maintenance services to the customer under the contract.

On January 1, 2018, A adopts the new revenue standard. Company A is required to apply the guidance in the new revenue standard to this contract by using either the full retrospective or modified retrospective transition method. For illustrative purposes, the effects under both transition methods are shown below.

Under the new revenue standard, A concludes the following:

- The product and maintenance services are distinct performance obligations.
- Control of the product is transferred upon shipment (i.e., at contract inception).
- The maintenance services represent a stand-ready obligation that A satisfies over time by using a ratable recognition pattern.
- The $250 discount (calculated as the difference between the sum of the stand-alone selling prices of the product and maintenance services, respectively, and the transaction price) does not meet the criteria to be allocated entirely to one performance obligation. Therefore, the discount is allocated to the performance obligations on a relative stand-alone selling price basis.

The journal entries below illustrate what A would have recorded if it had applied the new revenue standard to the contract beginning at contract inception.

On January 1, 2015 (contract inception), to recognize revenue upon shipment of the product:

Cash 750
Contract asset 150
Revenue 900*

* $2,250 TTP × 40% allocation.
Example 16-5 (continued)

On December 31, 2015, to recognize revenue for the first year of maintenance services:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Revenue</th>
<th>Contract asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>300</td>
<td>270*</td>
<td>30</td>
</tr>
</tbody>
</table>

* ($2,250 × 60% allocation) ÷ 5 years.

On December 31, 2016, to recognize revenue for the second year of maintenance services:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Revenue</th>
<th>Contract asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>300</td>
<td>270*</td>
<td>30</td>
</tr>
</tbody>
</table>

* ($2,250 × 60% allocation) ÷ 5 years.

On December 31, 2017, to recognize revenue for the third year of maintenance services:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Revenue</th>
<th>Contract asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>300</td>
<td>270*</td>
<td>30</td>
</tr>
</tbody>
</table>

* ($2,250 × 60% allocation) ÷ 5 years.

On December 31, 2018, to recognize revenue for the fourth year of maintenance services (the year of adoption of the new revenue standard):

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Revenue</th>
<th>Contract asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>300</td>
<td>270*</td>
<td>30</td>
</tr>
</tbody>
</table>

* ($2,250 × 60% allocation) ÷ 5 years.

Full Retrospective Transition Method

The table below summarizes A's balance sheet and income statement presentation upon adoption of the new revenue standard under the full retrospective transition method.

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2016</th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,050</td>
<td>$1,350</td>
<td>$1,650</td>
<td>$1,950</td>
</tr>
<tr>
<td>Contract asset</td>
<td>120</td>
<td>90</td>
<td>60</td>
<td>30</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,170</td>
<td>1,440</td>
<td>1,710</td>
<td>1,980</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>—</td>
<td>270</td>
<td>270</td>
<td>270</td>
</tr>
</tbody>
</table>
Example 16-5 (continued)

Under the full retrospective transition method, A applies the new revenue standard to all contracts and adjusts its financial statements to reflect the accounting under ASC 606 for all periods presented. Accordingly, A restates its balance sheet and income statement information for the years ended December 31 of 2016 and 2017, respectively. To reflect the full retrospective application of the new revenue standard, A recognizes a cumulative adjustment to retained earnings (and a corresponding adjustment to the contract asset balance) as of the beginning of the earliest period presented (i.e., on January 1, 2016).

On January 1, 2016, A records the following journal entry for the cumulative adjustment:

| Contract asset | 120 |
| Retained earnings | 120 |

Modified Retrospective Transition Method

The table below summarizes A's balance sheet and income statement presentation upon adoption of the new revenue standard under the modified retrospective transition method.

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>January 1, 2018</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,350</td>
<td>$1,650</td>
<td>$1,650</td>
<td>$1,950</td>
</tr>
<tr>
<td>Contract asset</td>
<td>—</td>
<td>—</td>
<td>60</td>
<td>30</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,350</td>
<td>1,650</td>
<td>1,710</td>
<td>1,980</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>300</td>
<td>300</td>
<td>—</td>
<td>270</td>
</tr>
</tbody>
</table>

Under the modified retrospective transition method, A does not restate its balance sheet and income statement information for the years ended December 31 of 2016 and 2017, respectively. Rather, A applies the new revenue standard to only its financial information for reporting periods beginning on or after January 1, 2018. In addition, A recognizes a cumulative adjustment to retained earnings (and a corresponding adjustment to the contract asset balance) on January 1, 2018.

On January 1, 2018, A records the following journal entry for the cumulative adjustment:

| Contract asset | 60 |
| Retained earnings | 60 |

The example below illustrates the accounting for a newly created contract liability upon adoption of the new revenue standard under both the full retrospective and modified retrospective transition methods.

Example 16-6

Company A, a public company with a calendar year-end, is a retailer that offers a customer loyalty program under which A’s customers are rewarded with points on qualifying purchases that can be applied toward future purchases of A’s products. Specifically, customers receive one point for every $20 spent. Each point earned by a customer can be redeemed for $1 that can be applied toward a future purchase. The points expire after five years.
### Example 16-6 (continued)

On December 31, 2015, A sells to a customer a product with a cost of $280 for $400. As a result of the product sale, the customer earns 20 points, which the customer has the option to apply toward future purchases made on or before December 31, 2020. At the point of sale, A expects that (1) the customer will redeem 100 percent of its points (i.e., no breakage is expected) and (2) A will incur $12 in costs to satisfy the points awarded to the customer. On December 31, 2017, the customer redeems 15 points to acquire a free product (which cost A $9) and has 5 points remaining to be used before December 31, 2020. The customer does not redeem any points in 2018.

Under legacy U.S. GAAP (specifically, ASC 605), A uses the incremental cost accrual model to account for product sales under the loyalty program. Specifically, under ASC 605, A recognizes (1) revenue at the time of the initial sale and (2) an accrual for the expected costs of satisfying the points awarded. Consequently, A records the journal entries below in accordance with legacy U.S. GAAP.

**On December 31, 2015 (point of sale), to record the sale of the product:**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>400</td>
</tr>
<tr>
<td>Revenue</td>
<td>400</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>280</td>
</tr>
<tr>
<td>Inventory</td>
<td>280</td>
</tr>
</tbody>
</table>

**On December 31, 2015 (point of sale), to accrue the costs of satisfying the points awarded to the customer:**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>12</td>
</tr>
<tr>
<td>Loyalty liability</td>
<td>12</td>
</tr>
</tbody>
</table>

**On December 31, 2017, to account for the customer’s redemption of 15 points for goods that cost A $9:**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loyalty liability</td>
<td>9</td>
</tr>
<tr>
<td>Inventory</td>
<td>9</td>
</tr>
</tbody>
</table>
Example 16-6 (continued)

Before December 31, 2017, A recognizes the full amount of its sales as revenue (i.e., $400 from the sale on December 31, 2015), along with a liability of $12 for the costs it expects to incur to satisfy its loyalty obligation. On December 31, 2017, A reduces its liability by $9 to account for the redemption of 15 points for the free product. The table below summarizes the impact on A’s balance sheet and income statement presentation for the years ended December 31 of 2015, 2016, and 2017, respectively (assume that this is A’s only contract):

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 400</td>
<td>$ 400</td>
<td>$ 400</td>
</tr>
<tr>
<td>Inventory*</td>
<td>(280)</td>
<td>(280)</td>
<td>(289)</td>
</tr>
<tr>
<td>Loyalty liability</td>
<td>12</td>
<td>12</td>
<td>3</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>108**</td>
<td>108***</td>
<td>108***</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>400</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>292</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

* For simplicity, the amounts shown for inventory reflect the impact on A’s inventory balance and does not suggest that a negative inventory balance would be appropriate.

** Retained earnings of $108 are calculated as the difference between revenue of $400 and cost of goods sold of $292.

*** Because A did not recognize any net income in either the year ended December 31, 2016, or the year ended December 31, 2017, A's retained earnings balance of $108 does not change.

On January 1, 2018, A adopts the new revenue standard. Company A is required to apply the guidance in the new revenue standard to this contract by using either the full retrospective or modified retrospective transition method. For illustrative purposes, the effects under both transition methods are shown below.

Under the new revenue standard, Company A concludes the following:

- The loyalty points provide the customer with a material right and therefore represent a distinct performance obligation in the contract.
- Control of the product is transferred upon shipment (i.e., at contract inception).

The table below shows the respective stand-alone selling prices, allocation percentages, and amounts of the TTP allocated for the product sold and loyalty points awarded to A's customer on December 31, 2015:

<table>
<thead>
<tr>
<th>Item</th>
<th>SSP</th>
<th>Allocation Percentage</th>
<th>Amount of TTP Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product</td>
<td>$ 400</td>
<td>95.2% ($400 ÷ $420)</td>
<td>$ 380.80 ($400 × 95.2%)</td>
</tr>
<tr>
<td>Loyalty points</td>
<td>20</td>
<td>4.8% ($20 ÷ $420)</td>
<td>19.20 ($400 × 4.8%)</td>
</tr>
<tr>
<td>Total</td>
<td>420</td>
<td>100.0%</td>
<td>$ 400</td>
</tr>
</tbody>
</table>

The journal entries below illustrate what A would have recorded if it had applied the new revenue standard to the contract beginning at contract inception.
Example 16-6 (continued)

On December 31, 2015 (point of sale), to recognize revenue upon shipment of the product and a contract liability for the amount of the total transaction price allocated to the loyalty points and related cost of goods sold:

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2016</th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$400.00</td>
<td>$400.00</td>
<td>$400.00</td>
<td>$400.00</td>
</tr>
<tr>
<td>Revenue</td>
<td>380.80</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>19.20</td>
<td>19.20</td>
<td>4.80</td>
<td>4.80</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(280.00)</td>
<td>(280.00)</td>
<td>(289.00)</td>
<td>(289.00)</td>
</tr>
<tr>
<td>Inventory</td>
<td>280.00</td>
<td>280.00</td>
<td>280.00</td>
<td>280.00</td>
</tr>
</tbody>
</table>

On December 31, 2017, to account for the customer’s redemption of 15 points:

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2016</th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract liability</td>
<td>14.40*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>14.40*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>9</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>9</td>
<td>9</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Both the amount of revenue recognized and the corresponding adjustment to the contract liability are calculated as ($19.20 of the TTP allocated to the loyalty points ÷ 20 points total) × 15 points redeemed. The cost of goods provided for free remains $9.

Full Retrospective Transition Method

The table below summarizes the impact on A’s balance sheet and income statement presentation upon adoption of the new revenue standard under the full retrospective transition method.

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2016</th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$400.00</td>
<td>$400.00</td>
<td>$400.00</td>
<td>$400.00</td>
</tr>
<tr>
<td>Inventory</td>
<td>(280.00)</td>
<td>(280.00)</td>
<td>(289.00)</td>
<td>(289.00)</td>
</tr>
<tr>
<td>Contract liability</td>
<td>19.20</td>
<td>19.20</td>
<td>4.80</td>
<td>4.80</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>100.80*</td>
<td>100.80**</td>
<td>106.20***</td>
<td>106.20**</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2016</th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income statement</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>—</td>
<td>—</td>
<td>14.40</td>
<td>—</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>—</td>
<td>—</td>
<td>9.00</td>
<td>—</td>
</tr>
</tbody>
</table>

* Retained earnings of $100.80 are calculated as the difference between recognized revenue of $380.80 and recognized cost of goods sold of $280, which are recorded in the December 31, 2015, journal entries above.

** Because A did not recognize any net income in either the year ended December 31, 2016, or the year ended December 31, 2018, A’s retained earnings balance does not change from the prior year-end.

*** Retained earnings of $106.20 are calculated as the sum of the prior-year retained earnings balance of $100.80 and the current-year net income (revenue of $14.40 less cost of goods sold of $9).

Under the full retrospective transition method, A applies the new revenue standard to all contracts and adjusts its financial statements to reflect the accounting under ASC 606 for all periods presented. Accordingly, A restates its balance sheet and income statement information for the years ended December 31 of 2016 and 2017, respectively. To reflect the full retrospective application of the new revenue standard, A recognizes a cumulative adjustment to retained earnings (and a corresponding adjustment to the contract liability balance) as of the beginning of the earliest period presented (i.e., on January 1, 2016).
Example 16-6 (continued)

On January 1, 2016, A records the following journal entry for the cumulative adjustment:

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loyalty liability</td>
<td>12</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>7.20*</td>
</tr>
<tr>
<td>Contract liability</td>
<td>19.20</td>
</tr>
</tbody>
</table>

* The adjustment to retained earnings is calculated as the difference between the loyalty accrual of $12 recognized under legacy U.S. GAAP and the portion of the TTP ($19.20) allocated to the loyalty points under the new revenue standard.

Modified Retrospective Transition Method

The table below summarizes the impact on A's balance sheet and income statement presentation upon adoption of the new revenue standard under the modified retrospective transition method.

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2016</th>
<th>December 31, 2017</th>
<th>January 1, 2018</th>
<th>December 31, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$400.00</td>
<td>$400.00</td>
<td>$400.00</td>
<td>$400.00</td>
</tr>
<tr>
<td>Inventory</td>
<td>(280.00)</td>
<td>(289.00)</td>
<td>(289.00)</td>
<td>(289.00)</td>
</tr>
<tr>
<td>Contract liability</td>
<td>—</td>
<td>—</td>
<td>4.80</td>
<td>4.80</td>
</tr>
<tr>
<td>Loyalty liability</td>
<td>12.00</td>
<td>3.00</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>108.00*</td>
<td>108.00**</td>
<td>106.20***</td>
<td>106.20**</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

* Retained earnings of $108 are calculated as the difference between revenue of $400 and cost of goods sold of $292 recorded on December 31, 2015 (in accordance with the guidance in ASC 605 as applied from contract inception).

** Because A did not recognize any net income in either the year ended December 31, 2016, or the year ended December 31, 2018, A's retained earnings balance does not change from the prior year-end.

*** Upon adopting the new revenue standard, A recognizes a cumulative-effect adjustment to reduce retained earnings by $1.80 on January 1, 2018.

Under the modified retrospective transition method, A does not restate its balance sheet and income statement information for the years ended December 31 of 2016 and 2017, respectively. Rather, A applies the new revenue standard to only its financial information for reporting periods beginning on or after January 1, 2018. In addition, A recognizes a cumulative adjustment to retained earnings (and a corresponding adjustment to the contract liability balance) on January 1, 2018.

On January 1, 2018, A records the following journal entry for the cumulative adjustment:

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loyalty liability</td>
<td>3</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1.80</td>
</tr>
<tr>
<td>Contract liability</td>
<td>4.80</td>
</tr>
</tbody>
</table>
16.2.5 Transition and Scope Considerations for Lessors

16.2.5.1 Separation of Lease and Nonlease Components for Lessors Upon Adoption of ASC 606

As stated in ASC 606-10-15-2, the new revenue standard does not apply to lease contracts within the scope of ASC 840 (or ASC 842, upon adoption of the new leasing standard). Although lease contracts are generally outside the scope of the new revenue standard, ASC 606-10-15-4 states that a “contract with a customer may be partially within the scope of [ASC 606] and partially within the scope of other Topics listed in paragraph 606-10-15-2.” An example of a contract that may be partially within the scope of ASC 606 and partially within the scope of another ASC topic is a lease contract entered into by a lessor that contains both lease and service elements.\(^6\)

Under current lease accounting guidance, the scope guidance in ASC 840-10-15-19 states the following (pending content effective upon adoption of the new revenue standard (in braces)):

For purposes of applying this Topic, payments and other consideration called for by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into:

a. Those for the lease, including the related executory costs and profits thereon

b. Those for other services on a relative fair value basis (relative standalone selling price basis), consistent with the guidance in paragraph 605-25-15-3A(b)(paragraph 606-10-15-4 and paragraphs 606-10-32-28 through 32-41). [Emphasis added]

ASC 840 further states that executory costs (such as a lessor’s property taxes, insurance, and maintenance) are excluded from the lessor’s minimum lease payments for purposes of lease classification and measurement. Although these costs are excluded from the lessor’s minimum lease payments, the costs are generally still considered part of the lease contract in accordance with ASC 840-10-15-19(a) rather than “other services” or substantial services\(^7\) that are separated and excluded from the scope of ASC 840. That is, executory costs are generally not separately accounted for under legacy revenue recognition guidance in ASC 605.

In addition, ASC 605-25-55-3 contains the following example clarifying when to apply the allocation guidance in ASC 605 and that in ASC 840:

For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30. Consider an arrangement that includes the lease of equipment under an operating lease, the maintenance of the leased equipment throughout the lease term (executory cost), and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the deliverables subject to the guidance in Subtopic 840-20 and the other deliverables using the relative selling price method. (Although Topic 840 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment and the related maintenance as deliverables subject to the guidance in that Topic.) The guidance in Topic 840 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. [Subtopic 605-25] would be applied to further separate any deliverables not subject to the guidance in Topic 840 and to allocate the related arrangement consideration.

\(^6\) Note that this would not apply to lessees because a lessee does not perform services or generate revenue under a lease contract.

\(^7\) “Substantial services” is a term used in EITF Issue 01-8 to differentiate services not accounted for under lease accounting from executory costs accounted for under lease accounting. This distinction between maintenance services, which are executory costs that historically have been accounted for under ASC 840, and substantial services, which historically have been accounted for under ASC 605, was raised in EITF Issue 08-2 but was not further clarified.
In accordance with this illustrative example in ASC 605, deliverables within the scope of lease guidance (including both the leased asset and executory costs) would be within the scope of ASC 840 and subject to the allocation guidance in ASC 840. However, the separate deliverable of the sale of additional equipment would not be covered by ASC 840 and would instead be subject to the accounting and allocation guidance in ASC 605.

In contrast to this approach under ASC 840, upon adoption of the new leasing standard, a lessor will be required to separate lease and nonlease components in a contract (unless the scope criteria in ASC 842-10-15-42A are met and the lessor elects to use the practical expedient of combining lease and nonlease components, as discussed in Section 16.2.5.2). A common example of a nonlease component under ASC 842 is maintenance services (commonly referred to as common area maintenance (CAM) services) performed by the lessor, which may be currently accounted for as an executory cost under ASC 840, as illustrated above. That is, upon a lessor’s adoption of ASC 842, maintenance services will be considered a service within the scope of ASC 606 rather than an executory cost accounted for under lease accounting guidance.

**Connecting the Dots — Questions About Effect of Interaction Between ASC 606 and ASC 842 on Accounting for Nonlease Components**

Because the effective dates of ASC 606 and ASC 842 are not the same, questions have been raised about whether and, if so, when a lessor would be required to separate nonlease components currently accounted for as executory costs (e.g., CAM) and account for those activities as services within the scope of ASC 606. Specifically, stakeholders have questioned whether a lessor would be required to separately account for CAM under ASC 606 (1) upon the adoption of ASC 606, (2) upon the adoption of ASC 842, or (3) in some other manner.

After these questions were raised, we participated in informal meetings with both the FASB staff and the SEC staff to discuss the interaction between ASC 606 and ASC 842 and how adoption of the new revenue and new leasing standards will affect the accounting for nonlease components (e.g., CAM). On the basis of our discussions with both parties, our understanding is that a lessor would not be required, upon adoption of the new revenue standard, to separate existing executory costs accounted for under ASC 840 that will meet the definition of a nonlease component under ASC 842 (e.g., CAM) and account for those activities as services within the scope of ASC 606. However, we believe that while a lessor would not be required to separate nonlease components, it would be acceptable for a lessor to elect to separate nonlease components and account for them as revenue-generating activities upon adoption of ASC 606.

Upon adoption of ASC 842, a lessor’s accounting for executory costs in existing leases that historically have been accounted for under ASC 840 would depend on whether:

- The lessor elects the practical expedient in ASC 842-10-65-1(f) of not reassessing lease classification for existing leases at transition.
- The lessor does not elect the practical expedient in ASC 842-10-65-1(f), and the lessor’s lease classification changes.
- The lessor elects the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components.

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8 For public companies, ASC 606 is effective for annual reporting periods beginning after December 15, 2017, and interim periods therein.
9 For most public companies, ASC 842 is effective for annual reporting periods beginning after December 15, 2018, and interim periods therein (i.e., one year after the effective date of ASC 606).
Accordingly, a lessor should consider the following scenarios:

- **Scenario 1:** The lessor does not elect the practical expedient in ASC 842-10-65-1(f), and the lessor’s lease classification changes upon adoption of ASC 842 (excluding a change from sales-type to direct financing) — If a lessor’s lease classification changes upon adoption of ASC 842, the lessor must apply the guidance in the new leasing standard on separating components of a contract as of the lessor’s date of initial application, which, depending on the transition method elected, could be either (1) the beginning of the earliest period presented under ASC 842 (e.g., January 1, 2017, for calendar-year public entities) or (2) the date of adoption (e.g., January 1, 2019, for calendar-year public entities) when the lessor uses the Comparatives Under 840 transition method. Accordingly, the lessor would be required to separate, and allocate consideration to, nonlease components (e.g., CAM services) unless the lessor elects the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components. If the lessor either does not qualify for the practical expedient in ASC 842-10-15-42A or does not elect to use it, the nonlease components would be accounted for in accordance with the revenue recognition guidance in ASC 606.

- **Scenario 2:** The lessor’s lease classification does not change upon adoption of ASC 842 because the lessor either (1) elects to apply the practical expedient in ASC 842-10-65-1(f) of not reassessing lease classification for existing leases at transition or (2) elects instead to reevaluate classification, but the lease classification does not change (or changes only from sales-type to direct financing) upon reassessment at transition — We believe that if a lessor’s lease classification does not change upon adoption of ASC 842 for either of the reasons stated above, the lessor’s accounting for executory costs in existing leases would depend on whether the lessor elects to use the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components:
  - **Scenario 2(a):** The lessor elects the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components — In this scenario, any executory costs historically accounted for under ASC 840 should be combined with the lease and nonlease components and accounted for under either ASC 606 (if the nonlease component is the predominant component in the contract) or ASC 842 (if the nonlease component is not the predominant component in the contract).
  - **Scenario 2(b):** The lessor does not elect the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components — We believe that in this scenario, it is acceptable for a lessor to account for executory costs that transfer a good or service to the lessee, including CAM, either as (1) a nonlease component under ASC 606 (i.e., separately from the lease component) by aligning existing leases to the lessor’s policy election of separating nonlease components under ASC 842 or (2) part of the lease component under ASC 842 (i.e., as if the lessor were “running off” its existing leases in a manner consistent with its accounting treatment under ASC 840).

In contrast to the discussion above on executory costs (including maintenance services), an entity should account for “other services” or substantial services that are not within the scope of ASC 840 in accordance with the guidance in the new revenue standard as of the effective date applicable to the entity.

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10 For further discussion of the ASC 842 transition methods, see Chapter 16 of Deloitte’s *A Roadmap to Applying the New Leasing Standard*.
16.2.5.2 Lessor Practical Expedient

ASC 842-10

15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not 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 component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.

b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3.

In July 2018, the FASB issued ASU 2018-11, under which lessors may elect not to separate lease and nonlease components when certain conditions are met. A lessor may elect to combine lease and associated nonlease components provided that the nonlease component(s) would otherwise be accounted for under ASC 606 and both of the conditions in ASC 842-10-15-42A(a) and (b) (“Criterion A” and “Criterion B”) are met.

The ASU also clarifies that the presence of a nonlease component that is ineligible for the practical expedient does not preclude a lessor from electing the expedient for the lease component and nonlease component(s) that meet the criteria. Rather, the lessor would account for the nonlease components that do not qualify for the practical expedient separately from the combined lease and nonlease components that do qualify.

Connecting the Dots — Assessing the Timing and Pattern of Transfer

In the final ASU, the Board amended Criterion A to focus on the timing and pattern of transfer (i.e., a “straight-line pattern of transfer . . . to the customer over the same time period”) rather than on the timing and pattern of revenue recognition (as was originally proposed). The purpose of this amendment was to address concerns that the originally proposed practical expedient was unnecessarily restrictive and excluded contracts with variable consideration from its scope, since variable payments are accounted for differently under ASC 606 than they are under ASC 842.

The FASB originally proposed that a lessor should always be required to account for the combined component as a lease under ASC 842 in a manner consistent with a similar practical expedient afforded to lessees. However, on the basis of feedback it received, the Board revised the final ASU to require an entity to perform another evaluation to determine whether the combined unit of account is accounted for as a lease under ASC 842 or as a revenue contract under ASC 606. Specifically, an entity should determine whether the nonlease component (or components) associated with the lease component is the predominant component of the combined component. If so, the entity is required to account for the combined component in accordance with ASC 606. Otherwise, the entity must account for the combined component as an operating lease in accordance with ASC 842.

Connecting the Dots — An Entity Will Need to Use Judgment to Determine the Predominant Component

As indicated in the ASU’s Background Information and Basis for Conclusions, the FASB decided not to include a separate definition or threshold for determining whether “the nonlease component is the predominant component of the combined component.” Rather, the Board indicates that a lessor should consider whether the lessee would “ascribe more value to the
nonlease component(s) than to the lease component.” Further, the Board acknowledged that the term “predominant” is used elsewhere in U.S. GAAP, including ASC 842 and ASC 606.

The FASB also indicates that it is comfortable with allowing entities to use judgment in making this determination. The Board explains that it does not expect that an entity will need to perform a detailed quantitative analysis or allocation to determine whether the nonlease component is predominant. Rather, it is sufficient if an entity can reasonably determine whether to apply ASC 842 or ASC 606.

At its March 28, 2018, meeting, the Board discussed a scenario in which the components were evenly split (e.g., a 50/50 split of value) and suggested that, in such circumstances, the combined component should be accounted for under ASC 842 because the nonlease component is not predominant. That is, the entity would need to demonstrate that the predominant element is the nonlease component; otherwise, the combined unit of account would be accounted for as a lease under ASC 842.

We believe that the final language in the ASU is intended to indicate that an entity would need to determine whether the lease or nonlease component (or components) is larger (i.e., has more value); only when the nonlease component is larger should the combined component be accounted for under ASC 606.

16.2.5.3 Lessor Reallocation of Consideration Upon Adoption of ASC 606

At its June 21, 2017, Board meeting, the FASB addressed another transition question about whether (1) the application of ASC 606 to prior periods in transition should have an impact only on the revenue components of a contract or (2) a lessor is required to reassess the accounting for the entire contract, including lease components. The accounting for the lease components could change if the transaction price is allocated on a relative stand-alone selling price basis and the amount allocated to the lease components is affected by the adoption of ASC 606 (e.g., the lease classification could change).

The Board decided that an entity is not required to reallocate contract consideration between revenue and lease components when it adopts ASC 606. That is, application of the new revenue standard should affect only the accounting for the revenue components of contracts and should not affect the accounting for the lease components.

For example, assume that a five-year contract includes a lease component accounted for under ASC 840 (or ASC 842, if early adopted) and a substantial service accounted for under ASC 605. Consideration for the contract is $150,000 (or $30,000 per year), of which $100,000 was allocated to the lease component and $50,000 was allocated to the service. In addition, assume that the contract provides the right to renew the substantial service at a significant discount and that this right would be identified as a material right under ASC 606 but was not identified as a separate unit of accounting under ASC 605. Upon transition to ASC 606, the entity determines that there are three components or performance obligations in the contract: (1) the lease component, (2) the substantial service, and (3) the material right. On the basis of the FASB’s view expressed above, only the $50,000 that was previously allocated to the substantial service would be reallocated between the two revenue elements (the substantial service and the material right). The $100,000 that was originally allocated to the lease component under ASC 840 would not be reallocated as a result of adopting ASC 606.
Chapter 17 — Nonpublic-Entity Elections

17.1 Background

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” (PBE). 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 PBEs 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 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 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.

### 17.2 Disclosure Elections

The Background Information and 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 15), 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 entities related to (1) the increased costs that nonpublic entities would incur to meet the expanded 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.

The table below summarizes the disclosures required by ASU 2014-09 that a nonpublic entity may elect not to apply (the ASU’s disclosure requirements are covered in Chapter 15 as well as in the left-hand column below).

<table>
<thead>
<tr>
<th>Full Retrospective</th>
<th>Election for Nonpublic Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>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 15.2)</td>
<td>None.</td>
</tr>
<tr>
<td><strong>Full Retrospective</strong></td>
<td><strong>Election for Nonpublic Entities</strong></td>
</tr>
<tr>
<td>------------------------</td>
<td>-----------------------------------</td>
</tr>
<tr>
<td>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 15.2.1)</td>
<td>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 15.2.1)</td>
</tr>
<tr>
<td>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 (ASC 606-10-50-8 through 50-10) and (2) the amount of revenue recognized that is related to performance obligations satisfied in prior periods (ASC 606-10-50-12A). (See Sections 15.2.2 and 15.2.3)</td>
<td>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 15.2.2.3)</td>
</tr>
<tr>
<td>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 15.2.3)</td>
<td>None.</td>
</tr>
<tr>
<td>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 obligations” and when the entity expects to recognize that amount as revenue. (ASC 606-10-50-13 through 50-15; see Section 15.2.3.3)</td>
<td>An entity may elect not to provide these disclosures. (ASC 606-10-50-16; see Section 15.2.3.3)</td>
</tr>
<tr>
<td>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 15.3 through 15.3.2)</td>
<td>In accordance with ASC 606-10-50-21, an entity may elect not to provide any or all of the following disclosures:</td>
</tr>
<tr>
<td></td>
<td>• An explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to the customer.</td>
</tr>
<tr>
<td></td>
<td>• For performance obligations satisfied at a point in time, the significant judgments used in evaluating when a customer obtains control.</td>
</tr>
<tr>
<td></td>
<td>• 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.</td>
</tr>
<tr>
<td>Information about an entity’s accounting for costs of obtaining or fulfilling a contract (including account balances and amortization methods). (ASC 340-40-50-2 and 50-3; see Section 15.4)</td>
<td>(ASC 606-10-50-21; see Section 15.3.2)</td>
</tr>
<tr>
<td>Information about the entity’s policy decisions (i.e., when the entity used the practical expedients allowed by the ASU). (ASC 606-10-50-14 through 50-16 and ASC 606-10-50-22; see Sections 6.4.1, 15.2.3.3.1, and 15.5)</td>
<td>An entity may elect not to provide these disclosures. (ASC 606-10-50-14 through 50-16 and ASC 606-10-50-23; see Sections 15.2.3.3.1 and 15.5)</td>
</tr>
</tbody>
</table>
Interim reporting requirements, including those related to disclosure, are outlined in ASC 270. In particular, public entities 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:

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.

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 606-10-50-12A.

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.

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.

17.3 Effective Date

In August 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. Further, in June 2020, the FASB issued ASU 2020-05, which permits nonpublic entities that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, to adopt ASC 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. Since the deferral is not mandatory, nonpublic entities may still elect to adopt ASC 606 in accordance with previous guidance as provided by ASU 2015-14 (i.e., for annual reporting periods beginning after December 15, 2018, and for interim reporting periods within annual reporting periods beginning after December 15, 2019).
It should also be noted that nonpublic entities could have elected 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.

In addition, certain PBEs that would otherwise not meet the definition of a PBE except for a requirement to include, or the inclusion of their financial statements, in another entity’s filing were provided effective-date relief as described in Section 16.1.2.

**Connecting the Dots — The “One-Year” or “Two-Year” Delay for Nonpublic Entities**

The effective-date relief for nonpublic entities under the guidance in ASU 2014-09, as amended by ASU 2015-14, 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 were required to adopt the new revenue standard for annual periods beginning after December 15, 2017 (one year earlier than nonpublic entities that have issued financial statements or made financial statements available for issuance on or before June 3, 2020). However, public entities were also required to adopt the new guidance for interim periods within those annual periods. Therefore, a calendar-year-end public entity will have applied the new revenue standard when presenting its results for the first quarter of 2018 (i.e., the period ended March 31, 2018), which were most likely issued in April or May 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 entity would typically produce the results of its year ended December 31, 2019, in March or April 2020. In addition, if a calendar-year-end nonpublic entity’s financial statements for an interim period are required or are otherwise produced and the nonpublic entity issued financial statements or made financial statements available for issuance on or before June 3, 2020, 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.

If a calendar-year-end nonpublic entity did not issue its financial statements or make them available for issuance on or before June 3, 2020, its effective-date relief would be described as a two-year delay. That is, if the calendar-year-end nonpublic entity elected to defer its adoption of ASC 606 in accordance with the optional relief provided by ASU 2020-05, it would first adopt ASC 606 for its annual period ending December 31, 2020, and would not be required to adopt ASC 606 for any interim period within that annual period.

The following example illustrates how nonpublic entities would apply the new revenue standard’s effective-date guidance if they issued financial statements or made their financial statements available for issuance on or before June 3, 2020 (i.e., they were subject to the effective date in ASU 2015-14):
Example 17-1

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 PBE, 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.

Companies X and Y elected to adopt the new revenue standard as of the mandatory effective date; accordingly, each of these companies were 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 was not required to (and therefore did not) adopt the new revenue standard as of June 30, 2019, and instead continued to apply legacy U.S. GAAP (i.e., ASC 605 or other industry-specific GAAP) when it reported its interim financial information. However, Z determined 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 adopted the new revenue standard as of December 31, 2019, and they each reported their financial statements under the new revenue standard in March 2020 for the full year ended December 31, 2019. In August 2019, Y presented its interim financial statements for June 30, 2019, by applying legacy U.S. GAAP; consequently, Y revised the results of the period from January 1, 2019, to June 30, 2019, to reflect the change from legacy U.S. GAAP to the guidance in ASC 606 when it provided its full-year annual results (although the interim financial information previously issued under legacy U.S. GAAP does not need to be reissued since it was compliant with U.S. GAAP). Company Z, in contrast to Y, elected to adopt the new standard when it reported its interim results in August 2019 (i.e., when Z produced its interim financial statements for June 30, 2019, it presented those results under the new guidance in ASC 606). Consequently, Z provided its results in August 2019 by using the new revenue standard, whereas X and Y provided their results under the new guidance in March 2020. The following table summarizes these facts:

<table>
<thead>
<tr>
<th>Reporting Requirements</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal year-end</td>
<td>December 31</td>
<td>December 31</td>
<td>December 31</td>
</tr>
<tr>
<td>Interim reporting</td>
<td>N/A</td>
<td>June 30</td>
<td>June 30</td>
</tr>
<tr>
<td>Fiscal year of adoption</td>
<td>Fiscal year 2019</td>
<td>Fiscal year 2019</td>
<td>Fiscal year 2019</td>
</tr>
<tr>
<td>Interim period of adoption</td>
<td>N/A</td>
<td>Fiscal year 2020</td>
<td>Fiscal year 2019</td>
</tr>
</tbody>
</table>

Depending on the facts and circumstances, including the needs of financial statement users, it might be beneficial for nonpublic entities to use an approach similar to that of Z, as outlined above. When using such an approach, a nonpublic entity 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).

17.4 Effective Date for an SEC Registrant (and Its Predecessor) in an Initial Registration Statement

As discussed in Section 16.1, the effective date of the new revenue standard for annual reporting periods varies as follows depending on (1) the type of entity applying the guidance and (2) when (or whether) the financial statements have been issued or made available for issuance:

- PBEs and certain other specified entities should apply the guidance in the new revenue standard for annual reporting periods beginning after December 15, 2017 (with early adoption permitted for annual reporting periods beginning after December 15, 2016).
• All other entities that have issued their financial statements or made financial statements available for issuance on or before June 3, 2020, should apply the guidance in the new revenue standard for annual reporting periods beginning after December 15, 2018.

• All other entities that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, may apply the guidance in the new revenue standard for annual reporting periods beginning after December 15, 2019 (as a result of the amendments in ASU 2020-05).

When financial statements of an SEC registrant (and its predecessor) are included in the registrant’s initial registration statement, the determination of the appropriate adoption date depends on whether the registrant is an EGC:1

• Non-EGC registrant — When financial statements of a non-EGC registrant are included in that registrant’s initial registration statement, the registrant meets the definition of a PBE and therefore must use the PBE adoption date (e.g., January 1, 2018, if the registrant is a calendar-year entity).

• EGC registrant — An EGC benefits from various accommodations intended to make the initial public offering process more attractive. For example, an EGC is not required to adopt new or revised accounting standards as of the effective date for public entities2 if the EGC has elected to delay the effective date of such standards to the effective date for entities that are neither PBEs nor certain other specified entities. Therefore, an EGC that elects to take advantage of the extended transition provisions to adopt the new revenue standard may use the effective date for entities that are neither PBEs nor certain other specified entities (e.g., January 1, 2020, for annual periods, if the EGC is a calendar-year entity that has not issued its financial statements or made them available for issuance as of June 3, 2020) when the EGC’s financial statements are included in an initial registration statement or subsequent annual report.3 Note, however, that an EGC is not allowed to use private-entity accounting alternatives. Refer to Section 10230 of the FRM for additional guidance on EGC accommodations related to accounting standards transition periods.

An EGC may irrevocably elect to use public-entity adoption dates for all new or revised accounting standards. When an EGC makes such an election, the entity must use the PBE adoption date of the new revenue standard (e.g., January 1, 2018, if the entity is a calendar-year entity).

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1 For a discussion of the qualifications for EGC status and the accommodations applicable to EGCs, see Section 1.6 of Deloitte’s A Roadmap to Initial Public Offerings.

2 The term “public entity” is generally used to refer to an entity that files its financial statements with the SEC. However, public or nonpublic entities may be variously defined in U.S. GAAP depending on which ASC topic is being applied. Some ASC topics may refer to a “public business entity” as defined in ASU 2013-12. For additional information, refer to Chapter 2 for the definition of a “public business entity” as that term is used in ASU 2014-09.

3 If an EGC elects to apply the extended transition provisions, it should include a risk factor that (1) explains that the election allows the entity to delay adoption of new or revised accounting standards and (2) states that the entity’s financial statements may not be comparable to those of entities that comply with the public-entity effective dates.
Chapter 18 — Sales of Nonfinancial Assets Within the Scope of ASC 610-20

18.1 Overview and Background

18.2 Scope of ASC 610-20

18.3 Unit of Account

18.4 Gain or Loss Recognition for Nonfinancial Assets

18.5 Exchanges of Nonfinancial Assets for Noncontrolling Interests

18.6 Effective Date and Transition

18.1 Overview and Background

ASC 610-20

05-1 This Subtopic provides guidance on the recognition of gains and losses on transfers of nonfinancial assets and in substance nonfinancial assets to counterparties that are not customers. Although the guidance in this Subtopic applies to contracts with noncustomers, it refers to revenue recognition principles in 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 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.

In response to stakeholder feedback indicating that (1) the meaning of the term “in-substance nonfinancial asset” is unclear because the new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is confusing and complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply, the FASB issued ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. The newly established guidance in ASC 610-20 (which consists of guidance in ASU 2014-09, as amended by ASU 2017-05) conforms the derecognition guidance on nonfinancial assets with the revenue model in ASC 606.
18.2 Scope of ASC 610-20

**15-2** Except as described in paragraph 610-20-15-4, the guidance in this Subtopic applies to gains or losses recognized upon the derecognition of nonfinancial assets and in substance nonfinancial assets. Nonfinancial assets within the scope of this Subtopic include intangible assets, land, buildings, or materials and supplies and may have a zero carrying value. In substance nonfinancial assets are described in paragraphs 610-20-15-5 through 15-8.

a. Subparagraph superseded by Accounting Standards Update No. 2017-05
b. Subparagraph superseded by Accounting Standards Update No. 2017-05.

**15-3** The guidance in this Subtopic applies to a transfer of an ownership interest (or a variable interest) in a consolidated subsidiary (that is not a business or nonprofit activity) only if all of the assets in the subsidiary are nonfinancial assets and/or in substance nonfinancial assets.

a. Subparagraph superseded by Accounting Standards Update No. 2017-05
b. Subparagraph superseded by Accounting Standards Update No. 2017-05
c. Subparagraph superseded by Accounting Standards Update No. 2017-05
d. Subparagraph superseded by Accounting Standards Update No. 2017-05
e. Subparagraph superseded by Accounting Standards Update No. 2017-05.

**15-4** The guidance in this Subtopic does not apply to the following:

a. A transfer of a nonfinancial asset or an in substance nonfinancial asset in a contract with a customer, see Topic 606 on revenue from contracts with customers
b. A transfer of a subsidiary or group of assets that constitutes a business or nonprofit activity, see Section 810-10-40 on consolidation
c. A real estate sale-leaseback transaction or a non-real-estate sale-leaseback transaction within the scope of Subtopic 360-20 on property, plant, and equipment — real estate sales or within the scope of Subtopic 840-40 on leases — sale-leaseback transactions
d. A conveyance of oil and gas mineral rights within the scope of Subtopic 932-360 on extractive activities — oil and gas
e. A transaction that is entirely accounted for in accordance with Topic 860 on transfers and servicing (for example, a transfer of investments accounted for under Topic 320 on investments — debt and equity securities, Topic 323 on investments — equity method and joint ventures, Topic 325 on investments — other, Topic 815 on derivatives and hedging, and Topic 825 on financial instruments)
f. A transfer of nonfinancial assets that is part of the consideration in a business combination within the scope of Topic 805 on business combinations, see paragraph 805-30-30-8
g. A nonmonetary transaction within the scope of Topic 845 on nonmonetary transactions
h. A lease contract within the scope of Topic 840 on leases
i. An exchange of takeoff and landing slots within the scope of Subtopic 908-350 on airlines — intangibles
j. A contribution of cash and other assets, including a promise to give, within the scope of Subtopic 720-25 on other expenses — contributions made or within the scope of Subtopic 958-605 on not-for-profit entities — revenue recognition
k. A transfer of an investment in a venture that is accounted for by proportionately consolidating the assets, liabilities, revenues, and expenses of the venture as described in paragraph 810-10-45-14
l. A transfer of nonfinancial assets or in substance nonfinancial assets solely between entities or persons under common control, such as between a parent and its subsidiaries or between two subsidiaries of the same parent.
## ASC 610-20 (continued)

### Pending Content (Transition Guidance: ASC 825-10-65-2)

**15-4** The guidance in this Subtopic does not apply to the following:

- a. A transfer of a nonfinancial asset or an in substance nonfinancial asset in a contract with a customer, see Topic 606 on revenue from contracts with customers
- b. A transfer of a subsidiary or group of assets that constitutes a business or nonprofit activity, see Section 810-10-40 on consolidation
- c. A real estate sale-leaseback transaction or a non-real-estate sale-leaseback transaction within the scope of Subtopic 360-20 on property, plant, and equipment — real estate sales or Subtopic 840-40 on leases — sale-leaseback transactions
- d. A conveyance of oil and gas mineral rights within the scope of Subtopic 932-360 on extractive activities — oil and gas
- e. A transaction that is entirely accounted for in accordance with Topic 860 on transfers and servicing (for example, a transfer of investments accounted for under Topic 320 on investments — debt securities, Topic 321 on investments — equity securities, Topic 323 on investments—equity method and joint ventures, Topic 325 on investments — other, Topic 815 on derivatives and hedging, and Topic 825 on financial instruments)
- f. A transfer of nonfinancial assets that is part of the consideration in a business combination within the scope of Topic 805 on business combinations, see paragraph 805-30-30-8
- g. A nonmonetary transaction within the scope of Topic 845 on nonmonetary transactions
- h. A lease contract within the scope of Topic 840 on leases
  - i. An exchange of takeoff and landing slots within the scope of Subtopic 908-350 on airlines — intangibles
  - j. A contribution of cash and other assets, including a promise to give, within the scope of Subtopic 720-25 on other expenses — contributions made or within the scope of Subtopic 958-605 on not-for-profit entities — revenue recognition
- k. A transfer of an investment in a venture that is accounted for by proportionately consolidating the assets, liabilities, revenues, and expenses of the venture as described in paragraph 810-10-45-14
- l. A transfer of nonfinancial assets or in substance nonfinancial assets solely between entities or persons under common control, such as between a parent and its subsidiaries or between two subsidiaries of the same parent.
ASC 610-20 (continued)

Pending Content (Transition Guidance: ASC 842-10-65-1)

15-4 The guidance in this Subtopic does not apply to the following:
   a. A transfer of a nonfinancial asset or an in substance nonfinancial asset in a contract with a customer, see Topic 606 on revenue from contracts with customers
   b. A transfer of a subsidiary or group of assets that constitutes a business or nonprofit activity, see Section 810-10-40 on consolidation
   c. Sale and leaseback transactions within the scope of Subtopic 842-40 on leases
   d. A conveyance of oil and gas mineral rights within the scope of Subtopic 932-360 on extractive activities — oil and gas
   e. A transaction that is entirely accounted for in accordance with Topic 860 on transfers and servicing (for example, a transfer of investments accounted for under Topic 320 on investments — debt securities, Topic 321 on investments — equity securities, Topic 323 on investments — equity method and joint ventures, Topic 325 on investments — other, Topic 815 on derivatives and hedging, and Topic 825 on financial instruments)
   f. A transfer of nonfinancial assets that is part of the consideration in a business combination within the scope of Topic 805 on business combinations, see paragraph 805-30-30-8
   g. A nonmonetary transaction within the scope of Topic 845 on nonmonetary transactions
   h. A lease contract within the scope of Topic 842 on leases
   i. An exchange of takeoff and landing slots within the scope of Subtopic 908-350 on airlines — intangibles
   j. A contribution of cash and other assets, including a promise to give, within the scope of Subtopic 720-25 on other expenses — contributions made or within the scope of Subtopic 958-605 on not-for-profit entities — revenue recognition
   k. A transfer of an investment in a venture that is accounted for by proportionately consolidating the assets, liabilities, revenues, and expenses of the venture as described in paragraph 810-10-45-14
   l. A transfer of nonfinancial assets or in substance nonfinancial assets solely between entities or persons under common control, such as between a parent and its subsidiaries or between two subsidiaries of the same parent.

ASC 610-20 (as amended by ASU 2017-05) applies to all nonfinancial assets, not only to those within the scope of ASC 350 and ASC 360, if there is no other applicable guidance. For each nonfinancial asset, an entity would first determine whether the transfer of the nonfinancial asset is within the scope of ASC 606, ASC 810, or any other U.S. GAAP. For example, 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), and not within the scope of other applicable guidance ASC 610-20 would apply.
Changing Lanes — 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. In their analysis of whether control has been transferred under the new revenue standard, entities need to critically evaluate (1) whether it is “probable” that they will collect the consideration to which they will be entitled in exchange for transferring the real estate and (2) whether a seller’s postsale involvement should be accounted for as a separate performance obligation (i.e., whether the postsale involvement is distinct from the real estate).

An entity would continue to apply the derecognition guidance in ASC 810-10-40 when transfers or sales are not “in-substance nonfinancial assets” (see Section 18.2.1) and the nonfinancial assets are held within a subsidiary or are a group of assets that meets the definition of a business. Various types of transactions are subject to the scope exception in ASC 610-20-15-4. Among the most common of these transactions are sale-and-leaseback transactions (e.g., real estate sale-and-leaseback transactions), which should be accounted for under ASC 840-40 (or ASC 842-40, upon adoption of the new leasing standard). 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).

Changing Lanes — 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”). The sale-and-leaseback accounting model in ASC 840-40 (i.e., recognition of a sale resulting in the derecognition of the asset, followed by lease accounting applied to the leaseback) 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-lessee'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.”

If any of these three criteria are not met, the transaction is not accounted for as a sale, and other methods (e.g., financing or deposit method) should be used. 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 until the entity adopts the new leases guidance. After adopting that guidance, an entity would evaluate a sale-and-leaseback transaction under ASC 842-40, which does not carry forward the linkage to the guidance in ASC 360-20 on sales of real estate.

The decision tree below, which is adapted from ASU 2017-05, can help an entity determine whether assets promised to a counterparty are within the scope of ASC 610-20.
Chapter 18 — Sales of Nonfinancial Assets Within the Scope of ASC 610-20

* If the transfer includes other contractual arrangements that are not assets of the seller to be derecognized (e.g., guarantees), those contracts are separated and accounted for in accordance with other ASC topics or subtopics.
18.2.1 In-Substance Nonfinancial Assets

In addition to nonfinancial assets, ASC 610-20 (as amended by ASU 2017-05) applies to the derecognition of in-substance nonfinancial assets. While the guidance in ASC 360-20 contained references to in-substance assets (e.g., in-substance real estate), it would not have applied to transactions outside of real estate. The FASB therefore added the definition of an in-substance nonfinancial asset to the ASC master glossary.

**ASC 610-20**

In Substance Nonfinancial Assets

**15-5** An in substance nonfinancial asset is a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, an entity shall evaluate the underlying assets in those subsidiaries.

**15-6** When a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, and substantially all of the fair value of the assets promised to a counterparty in the contract is not concentrated in nonfinancial assets, an entity shall evaluate whether substantially all of the fair value of the assets promised to the counterparty in an individual subsidiary within the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets in an individual subsidiary is concentrated in nonfinancial assets, then the financial assets in that subsidiary are in substance nonfinancial assets. (See Case C of Example 1 in paragraphs 610-20-55-9 through 55-10.)

**15-7** When determining whether substantially all of the fair value of the assets promised to a counterparty in a contract (or an individual consolidated subsidiary within a contract) is concentrated in nonfinancial assets, cash or cash equivalents promised to the counterparty shall be excluded. Also, any liabilities assumed or relieved by the counterparty shall not affect the determination of whether substantially all of the fair value of the assets transferred is concentrated in nonfinancial assets.

**15-8** If all of the assets promised to a counterparty in an individual consolidated subsidiary within a contract are not nonfinancial assets and/or in substance nonfinancial assets, an entity shall apply the guidance in paragraph 810-10-40-3A(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

On the basis of the above definition of an in-substance nonfinancial asset, all business or nonprofit activities are excluded from the scope of ASC 610-20 and should be accounted for under the consolidation guidance in ASC 810-10. Further, all investments should be accounted for under the guidance in ASC 860 on transfers and servicing transactions, regardless of whether they are business or nonprofit activities or are in-substance nonfinancial assets.

**Connecting the Dots — ASU 2017-01 on Clarifying the Definition of a Business**

In January 2017, the FASB issued ASU 2017-01, which clarifies and narrows the definition of a business. An entity should apply that definition when applying the guidance in ASU 2017-05. It is likely that an entity will consider fewer real estate transactions to be businesses under the revised definition than it did under legacy guidance and that more transactions will therefore be accounted for in accordance with ASC 610-20. For additional information about ASU 2017-01, see Deloitte’s January 13, 2017, *Heads Up*.

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1 ASC 360-20, which provides guidance on real estate sale transactions, was partially superseded by ASC 606 and ASC 610-20. However, ASC 360-20 continues to apply to sale-and-leaseback transactions involving real estate assets until the amendments in ASU 2016-02 on leases become effective.
The examples below illustrate how an entity would determine whether a contract includes an in-substance nonfinancial asset.

**Example 18-1**

An entity enters into a contract with a counterparty (not a customer) to transfer a piece of equipment subject to a lease agreement (i.e., the equipment is presently being leased and used by an independent third party). As of the sale date, the equipment has a fair value of $8 million. In addition, the sale contract transfers the outstanding receivable balance of the lease (i.e., a financial asset) with a fair value of $250,000.

The assets transferred do not meet the definition of a business under ASU 2017-01. Since the entity concludes that substantially all of the fair value of the assets promised in the contract is concentrated in nonfinancial assets, the receivables promised in the contract meet the definition of in-substance nonfinancial assets. Thus, the contract, including both assets (the equipment and the receivables), is within the scope of ASC 610-20 and therefore should be accounted for in accordance with the derecognition guidance of that subtopic.

**Example 18-2**

Assume the same facts as in Example 18-1, except that the fair value of the receivables is $1.5 million. In this example, the entity concludes that substantially all of the fair value of the assets promised in the contract is not concentrated in nonfinancial assets and that as a result, the financial assets in the contract do not meet the definition of in-substance nonfinancial assets. Therefore, as further discussed in Section 18.2.2 below, the entity should apply the guidance in ASC 606-10-15-4 in determining the separation and measurement of the assets in the contract. The equipment (a nonfinancial asset) is within the scope of ASC 610-20 and therefore should be accounted for in accordance with the derecognition guidance of that subtopic, and the receivables should be accounted for under ASC 860 or other U.S. GAAP, if applicable.

**18.2.2 Contracts Partially Within the Scope of Other U.S. GAAP**

**ASC 610-20**

Contracts Partially Within the Scope of Other Topics

15-9 If the promises to a counterparty in a contract are not all nonfinancial assets or all nonfinancial assets and in substance nonfinancial assets, a contract may be partially within the scope of this Subtopic and partially within the scope of other Topics. For example, in addition to transferring nonfinancial assets and in substance nonfinancial assets that are within the scope of this Subtopic, an entity may issue a guarantee to the counterparty that is within the scope of Topic 460 on guarantees. An entity shall apply the guidance in paragraph 606-10-15-4 to determine how to separate and measure one or more parts of a contract that are within the scope of other Topics. (See also Case A of Example 1 in paragraphs 610-20-55-2 through 55-5 and Case C of Example 1 in paragraphs 610-20-55-9 through 55-10.)

Assets in a legal contract or in a consolidated subsidiary can be transferred to a counterparty. The form of the transaction affects which guidance an entity should apply when determining how to account for a transaction in which not all assets promised to a counterparty are nonfinancial assets or in-substance nonfinancial assets.

**18.2.2.1 Sale or Transfer Through a Legal Contract**

If assets are transferred to a counterparty in a legal contract and the contract is partially within the scope of ASC 610-20 and partially within the scope of other guidance (i.e., not all assets promised in the contract are nonfinancial and in-substance nonfinancial assets), an entity should identify each unit of account and apply the separation and allocation guidance in ASC 606. Cases A and B of Example 1 in ASC 610-20, which are reproduced below, illustrate the application of this guidance.
Example 1 — Scope
Case A — Nonfinancial Assets, In Substance Nonfinancial Assets, and a Guarantee

**55-2** Seller enters into a contract to transfer real estate, the related operating leases, and accounts receivable to Buyer. Seller guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for two years after the sale. In the event that the cash flows are not sufficient, Seller is required to make a payment in the amount of the shortfall.

**55-3** Seller concludes that the assets promised in the contract are not a business within the scope of Topic 810 on consolidation and are not an output of Seller’s ordinary activities within the scope of Topic 606 on revenue from contracts with customers. In addition, assume that Seller concludes that substantially all of the fair value of the assets promised in the contract is concentrated in nonfinancial assets (that is, substantially all of the fair value is concentrated in the real estate and in-place lease intangible assets). Therefore, the accounts receivable promised in the contract are in substance nonfinancial assets. In accordance with the guidance in this Subtopic, all of the assets in the contract, including the accounts receivable, are within the scope of this Subtopic.

**55-4** Seller concludes that the guarantee, which is a liability of Seller, is within the scope of Topic 460 on guarantees. Therefore, Seller would apply the guidance in paragraph 606-10-15-4 to separate and measure the guarantee as described in paragraph 610-20-15-9.

**55-5** Seller's conclusions would be the same if it transferred the real estate, leases, and receivables by transferring ownership interests in a consolidated subsidiary. That is, Seller would still conclude that all of the assets in the subsidiary are nonfinancial assets and in substance nonfinancial assets within the scope of this Subtopic and that the guarantee is within the scope of Topic 460.

Case B — Nonfinancial Assets and Financial Assets

**55-6** Entity X enters into a contract to transfer machinery and financial assets, both of which have significant fair value. Entity X concludes that the assets promised in the contract are not a business within the scope of Topic 810 and are not an output of the entity's ordinary activities within the scope of Topic 606. Entity X also concludes that substantially all of the fair value of the assets promised in the contract is not concentrated in nonfinancial assets. Therefore, the financial assets promised in the contract are not in substance nonfinancial assets.

**55-7** In accordance with the guidance in paragraph 610-20-15-9, Entity X should derecognize only the machinery in accordance with this Subtopic. Entity X should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets.

18.2.2.2 Sale or Transfer Through One or More Subsidiaries

Unlike assets sold or transferred through a legal contract, the transferred assets of an individual subsidiary should not be separated. For example, when all or substantially all of the fair value of the transferred assets is not concentrated in nonfinancial assets, in-substance nonfinancial assets, or both, a transaction involving the transfer of ownership interests in a subsidiary is entirely excluded from the scope of ASC 610-20 and should be accounted for as an equity transaction in accordance with ASC 810. The Codification excerpt below, which is a continuation of Example 1, Case B, in ASC 610-20 as reproduced in Section 18.2.2.1 above, illustrates the application of this guidance.
Chapter 18 — Sales of Nonfinancial Assets Within the Scope of ASC 610-20

ASC 610-20

Example 1 — Scope . . .

55-8 If Entity X transfers the machinery and financial assets by transferring ownership interests in a consolidated subsidiary, it would still conclude that the financial assets are not in substance nonfinancial assets. As described in paragraph 610-20-15-8, if all of the assets promised to the counterparty in an individual consolidated subsidiary within a contract are not nonfinancial assets and/or in substance nonfinancial assets, those assets should not be derecognized in accordance with this Subtopic. Instead, Entity X should apply the guidance in paragraph 810-10-40-3A(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

Assets held in more than one subsidiary can also be transferred to a counterparty under a contract. To determine the accounting, an entity should first assess whether substantially all of the fair value of all assets under the contract is concentrated in nonfinancial assets. If it is not, the entity should evaluate whether substantially all of the fair value of the assets in any individual subsidiary under the contract is concentrated in nonfinancial assets, in which case the financial assets of that subsidiary are, in substance, nonfinancial assets within the scope of ASC 610-20. Example 1, Case C, in ASC 610-20, which is reproduced below, illustrates the application of this guidance.

ASC 610-20

Example 1 — Scope . . .
Case C — One Subsidiary That Holds Nonfinancial Assets and One Subsidiary That Holds Financial Assets

55-9 Entity A enters into a contract to transfer ownership interests in two consolidated subsidiaries to a single counterparty. Subsidiary 1 consists entirely of nonfinancial assets, and Subsidiary 2 consists entirely of financial assets. Assume that the assets in Subsidiary 1 and Subsidiary 2 have an equal amount of fair value. Entity A concludes that the transaction is not the transfer of a business within the scope of Topic 810 and that the subsidiaries are not outputs of the entity’s ordinary activities within the scope of Topic 606.

55-10 Entity A first considers whether substantially all of the fair value of the assets promised to the counterparty in the contract is concentrated in nonfinancial assets. Because the contract includes the transfer of ownership interests in one or more consolidated subsidiaries, Entity A evaluates the underlying assets in those subsidiaries. Entity A concludes that because both the financial assets and nonfinancial assets have an equal amount of fair value, substantially all of the fair value of the assets promised to the counterparty in the contract is not concentrated in nonfinancial assets. Entity A next considers whether substantially all of the fair value of the assets within Subsidiary 1 or Subsidiary 2 is concentrated in nonfinancial assets. Because the assets transferred within Subsidiary 1 are entirely nonfinancial assets, Entity A concludes that those assets are within the scope of this Subtopic. Entity A also concludes that the financial assets in Subsidiary 2 are not in substance nonfinancial assets and, therefore, are not within the scope of this Subtopic. Entity A should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets in Subsidiary 2 from the nonfinancial assets in Subsidiary 1 that are derecognized within the scope of this Subtopic.

18.2.3 Partial Sales

As noted in Section 18.1, ASU 2017-05 clarifies the accounting for partial sales of nonfinancial assets. Partial sales include 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 a building [or an asset] to a buyer but either retains an interest in the building [or the asset] or has an interest in the buyer).
Before adopting the new revenue standard, entities have accounted for partial sales principally under the transaction-specific guidance in ASC 360-20 on real estate sales, the industry-specific guidance in ASC 970-323, and (sometimes) ASC 845-10-30. ASU 2017-05 amends the guidance in ASC 970-323 to align it with the requirements in ASC 606 and ASC 610-20. It also eliminates ASC 360-20 as well as the guidance in the Exchanges of a Nonfinancial Asset for a Noncontrolling Ownership Interest subsection of ASC 845-10-30 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. As a result of these changes, any transfer of a nonfinancial asset in exchange for a noncontrolling ownership interest in another entity (including a noncontrolling ownership interest in a joint venture or other equity method investment) should be accounted for in accordance with ASC 610-20.

18.3 Unit of Account

ASU 2017-05 clarifies that the unit of account is defined as a distinct nonfinancial asset. At the inception of a contract, an entity should therefore identify each distinct nonfinancial and in-substance nonfinancial asset in accordance with the guidance on identifying distinct performance obligations in ASC 606 (see Chapter 5). The entity should then, in a manner consistent with the approach outlined in ASC 606 (see Chapters 7 and 8), allocate consideration to each distinct asset and derecognize the asset when a counterparty obtains control of it.

18.4 Gain or Loss Recognition for Nonfinancial Assets

ASC 610-20 applies many of the same principles as ASC 606 for determining the gain or loss to recognize when a nonfinancial asset or in-substance nonfinancial asset is derecognized. Specifically, ASC 610-20 incorporates the requirements for determining:

- When a contract exists (i.e., step 1).
- Which nonfinancial assets or in-substance nonfinancial assets are distinct (i.e., step 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).
- How to allocate the amount of consideration determined in step 3 to each distinct nonfinancial asset or in-substance nonfinancial asset (i.e., step 4).
- When control of any nonfinancial asset or in-substance nonfinancial asset is transferred 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 4.5 and 4.6). 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.

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2 In paragraph BC53 of ASU 2017-05, the FASB clarified that for a partial sales transaction structured as the sale of an ownership interest in a consolidated subsidiary, “an entity should evaluate whether it transfers control of the distinct underlying asset and not the ownership interest” in the legal entity that holds the asset.
Substantially all sales of nonfinancial assets and in-substance 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 nonfinancial assets such as real estate by using a control-based model rather than the risks-and-rewards model under legacy 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 a nonfinancial asset such as 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.

**Connecting the Dots — Transfer of Control in Real Estate Sales**

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized 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 8.4.5.2) 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.

### 18.4.1 Derecognition of Nonfinancial Assets or In-Substance Nonfinancial Assets

<table>
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<th>ASC 610-20</th>
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<tbody>
<tr>
<td><strong>25-1</strong> To recognize a gain or loss from the transfer of nonfinancial assets or in substance nonfinancial assets within the scope of this Subtopic, an entity shall apply the guidance in Topic 810 on consolidation and in Topic 606 on revenue from contracts with customers as described in paragraphs 610-20-25-2 through 25-7.</td>
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**Determining Whether an Entity Has a Controlling Financial Interest**

**25-2** An entity shall first evaluate whether it has (or continues to have) a controlling financial interest in the legal entity that holds the nonfinancial assets and/or in substance nonfinancial assets by applying the guidance in Topic 810 on consolidation. For example, if a parent transfers ownership interests in a consolidated subsidiary, the parent shall evaluate whether it continues to have a controlling financial interest in that subsidiary. Similarly, when an entity transfers assets directly to a counterparty (or a legal entity formed by the counterparty), the entity shall evaluate whether it has a controlling financial interest in the counterparty (or the legal entity formed by the counterparty).

**25-3** If an entity determines it has (or continues to have) a controlling financial interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets, it shall not derecognize those assets and shall apply the guidance in paragraphs 810-10-45-21A through 45-24.

**25-4** Any nonfinancial assets or in substance nonfinancial assets transferred that are held in a legal entity in which the entity does not have (or ceases to have) a controlling financial interest shall be further evaluated in accordance with the guidance in paragraphs 610-20-25-5 through 25-7.

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3 When recognizing a gain or loss on sales of nonfinancial assets or in-substance nonfinancial assets that are not contracts with customers, an entity must first consider whether, under ASC 810, it ceases to have a controlling financial interest in the legal entity that holds the nonfinancial assets or in-substance nonfinancial assets. If the controlling financial interest is lost, the entity should then consider whether control of the nonfinancial assets or in-substance nonfinancial assets is transferred in accordance with ASC 606 (see Section 18.4.1)
Applying Revenue Recognition Guidance

**25-5** After applying the guidance in paragraphs 610-20-25-2 through 25-4, an entity shall next evaluate a contract in accordance with the guidance in paragraphs 606-10-25-1 through 25-8. If a contract does not meet all of the criteria in paragraph 606-10-25-1, an entity shall not derecognize the nonfinancial assets or in substance nonfinancial assets transferred, and it shall apply the guidance in paragraph 350-10-40-3 to any intangible assets and the guidance in paragraph 360-10-40-3C to any property, plant, and equipment. An entity shall follow the guidance in paragraphs 606-10-25-6 through 25-8 to determine if and when a contract subsequently meets all of the criteria in paragraph 606-10-25-1.

**25-6** Once a contract meets all of the criteria in paragraph 606-10-25-1, an entity shall identify each distinct nonfinancial asset and distinct in substance nonfinancial asset promised to a counterparty in accordance with the guidance in paragraphs 606-10-25-19 through 25-22. An entity shall derecognize each distinct asset when it transfers control of the asset in accordance with paragraph 606-10-25-30. In some cases, control of each asset may transfer at the same time such that an entity may not need to separate and allocate consideration to each distinct nonfinancial asset and in substance nonfinancial asset. That may be the case, for example, when a parent transfers ownership interests in a consolidated subsidiary that holds nonfinancial assets (or nonfinancial assets and in substance nonfinancial assets) and ceases to have a controlling financial interest in the subsidiary in accordance with Topic 810. However, control of each asset may not transfer at the same time if the parent has control of some of the assets in accordance with paragraph 606-10-25-6 through 25-8 to determine if and when a contract subsequently meets all of the criteria in paragraph 606-10-25-1.

**25-7** For purposes of evaluating the indicators of the transfer of control in paragraph 606-10-25-30, if an entity has (or continues to have) a noncontrolling interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets as a result of the transaction, the entity shall evaluate the point in time at which the legal entity holding the assets obtains (or has) control (for example, by evaluating whether the legal entity can direct the use of, and obtain substantially all of the benefits from, each distinct nonfinancial asset or in substance nonfinancial asset within it). (See Case A of Example 2 in paragraphs 610-20-55-11 through 55-14.) If the entity does not have a noncontrolling interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets as a result of the transaction, it shall evaluate the point in time at which a counterparty (or counterparties, collectively) obtains control of the assets in the legal entity (for example, by evaluating whether a counterparty [or counterparties, collectively] can direct the use of, and obtain substantially all of the benefits from, each distinct nonfinancial asset or in substance nonfinancial asset within the legal entity).

To determine when to derecognize a nonfinancial asset or in-substance nonfinancial asset, an entity should first assess whether it has lost a controlling financial interest in the subsidiary (i.e., the legal entity that holds the asset). If the entity obtains a controlling financial interest in a new subsidiary that holds the nonfinancial asset after the transaction, or if the entity retains a controlling financial interest in an existing subsidiary that holds the asset (e.g., because the entity sold a noncontrolling ownership interest in a consolidated subsidiary), the entity should not derecognize the nonfinancial asset or in-substance nonfinancial asset. Instead, the entity should account for the transaction as an equity transaction in accordance with ASC 810.

However, if the entity has not obtained or retained a controlling financial interest in such legal entity that holds the asset, it should derecognize the nonfinancial asset or in-substance nonfinancial asset when it transfers control of the asset in a manner consistent with the principles in ASC 606 (see Chapter 8). That is, when evaluating whether or in what circumstances it is appropriate to derecognize the nonfinancial asset or in-substance nonfinancial asset, the entity should first evaluate whether it has lost a controlling financial interest in the legal entity by applying the guidance in ASC 810. If the entity determines that it has lost a controlling financial interest in the legal entity under ASC 810, it should then evaluate whether it has lost control of the nonfinancial asset or in-substance nonfinancial asset by applying the guidance in ASC 606. When evaluating whether control of the asset has been transferred under ASC 606, the
entity has to consider any repurchase agreements (e.g., a call option to repurchase the ownership interest in the legal entity) and may not be able to derecognize the nonfinancial asset, even though it no longer has a controlling financial interest in a subsidiary in accordance with ASC 810. Cases A and B of Example 2 in ASC 610-20, which are reproduced below, illustrate the application of this guidance.

**ASC 610-20**

**Example 2 — Transfer of Control**

**Case A — Control Transfers Under Topics 810 and 606**

55-11 Entity A owns 100 percent of Entity B, a consolidated subsidiary. Entity B holds title to land with a carrying amount of $5 million. Entity A concludes that the land is not an output of its ordinary activities within the scope of Topic 606 and that Entity B does not meet the definition of a business within the scope of Topic 810.

55-12 Entity A enters into a contract to transfer 60 percent of Entity B to Entity X for $6 million cash due at contract inception. For ease of illustration, assume that at contract inception the fair value of the 40 percent interest retained by Entity A is $4 million. Because all of the assets (the land) promised to Entity X in the contract are nonfinancial assets, Entity A concludes that it should derecognize the land in accordance with this Subtopic.

55-13 As described in paragraphs 610-20-25-2 through 25-7, Entity A first considers the guidance in Topic 810 and concludes that it no longer has a controlling financial interest in Entity B or in Entity X (the buyer). Entity A then determines that the contract meets the criteria in paragraph 606-10-25-1 and that control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30. Because Entity A continues to have a noncontrolling interest in Entity B, it evaluates the point in time at which Entity B, its former subsidiary, has control of the distinct nonfinancial asset as described in paragraph 610-20-25-7. Entity A concludes that it has transferred control of the distinct nonfinancial asset because Entity B controls the distinct nonfinancial asset. When evaluating the indicators of control in paragraph 606-10-25-30, Entity A concludes the following:

a. It has the present right to payment.
b. Entity B has legal title to the land.
c. It does not have physical possession of the asset because it cannot restrict or prevent other entities from accessing the land.
d. Entity B has the significant risks and rewards of ownership.
e. There is no acceptance clause (assumption). . . .

**Case B — Control Transfers Under Topic 810 but Not Under Topic 606**

55-15 Assume the same facts as in Case A, except that Entity A has the right but not the obligation to repurchase the 60 percent ownership interest in Entity B that it transferred to Entity X (that is, Entity A has a call option). The call option gives Entity A the right to repurchase the 60 percent ownership interest in 2 years for $7 million.

55-16 Entity A concludes that although the call option represents a variable interest in Entity B, it does not have a controlling financial interest in Entity B in accordance with the guidance in Topic 810. However, when evaluating whether control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30, Entity A considers the guidance on repurchase features in paragraphs 606-10-25-30(c) and 606-10-55-68 and concludes that it does not transfer control of the land. In addition, because the exercise price on the call option is an amount that is greater than the original selling price, the transaction is considered a financing agreement in accordance with the guidance in paragraph 606-10-55-68(b). Entity A does not derecognize the land and records a financial liability of $6 million in accordance with the guidance in paragraph 606-10-55-70. Entity A does not recognize an investment for its retained 40 percent ownership interest until it derecognizes the land.
Connecting the Dots — 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, upon adoption of the new leasing standard).

See Section 8.7 for further discussion of repurchase agreements and their impact on transferring control.

18.4.2 Gain or Loss Measurement

<table>
<thead>
<tr>
<th>ASC 610-20</th>
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<tr>
<td>32-2 When an entity meets the criteria to derecognize a distinct nonfinancial asset or a distinct in substance nonfinancial asset, it shall recognize a gain or loss for the difference between the amount of consideration measured and allocated to that distinct asset in accordance with paragraphs 610-20-32-3 through 32-6 and the carrying amount of the distinct asset. The amount of consideration promised in a contract that is included in the calculation of a gain or loss includes both the transaction price and the carrying amount of liabilities assumed or relieved by a counterparty.</td>
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To determine the transaction price, 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.

If an entity transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset in exchange for a noncontrolling interest, the entity shall consider the noncontrolling interest received from the counterparty as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24. Similarly, if a parent transfers control of a distinct nonfinancial asset or in substance nonfinancial asset by transferring ownership interests in a consolidated subsidiary but retains a noncontrolling interest in its former subsidiary, the entity shall consider the noncontrolling interest retained as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24. (See Case A of Example 2 in paragraphs 610-20-55-11 through 55-14.)

If a counterparty promises to assume or relieve a liability of an entity in exchange for a transfer of nonfinancial assets or in substance nonfinancial assets within the scope of this Subtopic, the transferring entity shall include the carrying amount of the liability in the consideration used to calculate the gain or loss. Although a liability assumed or relieved by a counterparty shall be included in the consideration used to calculate a gain or loss, an entity shall not derecognize the liability until it has been extinguished in accordance with the guidance in paragraph 405-20-40-1 (see paragraph 610-20-45-3 on how to present the liability if it is extinguished before or after the entity transfers control of the nonfinancial assets or in substance nonfinancial assets). If an entity transfers control of the nonfinancial assets or in substance nonfinancial assets before a liability is extinguished, it shall apply the guidance on constraining estimates of variable consideration in paragraph 606-10-32-11 to determine the carrying amount of the liability to be included in the gain or loss calculation.

An entity shall allocate the consideration calculated in accordance with the guidance in paragraphs 610-20-32-2 through 32-5 to each distinct nonfinancial asset or in substance nonfinancial asset by applying the guidance in paragraphs 606-10-32-28 through 32-41.

If the derecognition criteria are met (see Section 18.4.1), an entity should recognize a full gain or loss on derecognition of any nonfinancial or in-substance nonfinancial assets. The entity should include in the consideration received any liability assumed (or relieved) by the counterparty (e.g., mortgage loan on the building) when determining the gain or loss on the derecognition. In a manner consistent with the discussion in paragraph BC35 of ASU 2017-05, the entity should account for the derecognition of the asset and assumption of the liability together and accordingly recognize a single gain or loss inclusive of any liability assumed by the counterparty. Further, the entity should account for any noncontrolling ownership interest as noncash consideration, which should be measured at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-10-32-21 through 32-24 (see Section 6.5). Example 2, Case A, in ASC 610-20, which is reproduced below and is also discussed in Section 18.4.1, illustrates the application of this guidance.
ASC 610-20

Example 2 — Transfer of Control

Case A — Control Transfers Under Topics 810 and 606

Entity A owns 100 percent of Entity B, a consolidated subsidiary. Entity B holds title to land with a carrying amount of $5 million. Entity A concludes that the land is not an output of its ordinary activities within the scope of Topic 606 and that Entity B does not meet the definition of a business within the scope of Topic 810.

Entity A enters into a contract to transfer 60 percent of Entity B to Entity X for $6 million cash due at contract inception. For ease of illustration, assume that at contract inception the fair value of the 40 percent interest retained by Entity A is $4 million. Because all of the assets (the land) promised to Entity X in the contract are nonfinancial assets, Entity A concludes that it should derecognize the land in accordance with this Subtopic. . . .

Entity A derecognizes the land and calculates the gain or loss as the difference between the amount of consideration measured in accordance with the guidance in paragraphs 610-20-32-2 and 610-20-32-6 and the carrying amount of the land. The amount of the consideration is $10 million, which includes $6 million in cash plus $4 million for the fair value of the noncontrolling interest in Entity B. Entity A recognizes a gain of $5 million ($10 million consideration – $5 million carrying amount of the assets) and presents the gain in the income statement in accordance with the guidance in paragraph 360-10-45-5. In accordance with the guidance in paragraph 610-20-32-4, Entity A records the noncontrolling interest in Entity B at $4 million and subsequently accounts for that interest in accordance with other Topics.

18.4.2.1 Accounting for the Sale of a Nonfinancial Asset Within the Scope of ASC 610-20 That Involves a Guarantee

When a seller has entered into a contract to sell property and guarantee the buyer's return on the property, 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 nonfinancial asset within the scope of ASC 610-20 and a guarantee within the scope of ASC 460-10.

ASC 610-20-15-9 refers entities to ASC 606-10-15-4 for guidance on determining how to separate and measure elements in a contract that is within the scope of other topics. 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 element(s) — which may include other assets or services in addition to the property being sold — and any gain or loss would be recognized when (or as) control of each element 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 18-3

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 nonfinancial asset (i.e., 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 18-4

Assume the same facts as in Example 18-3 above, 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 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).

18.4.2.2 Variable or Contingent Consideration

Any contingent consideration included in the transaction price should be estimated and constrained in a manner consistent with ASC 606, as further discussed in Section 6.3.

Changing Lanes — Variable or Contingent Consideration

As discussed in Section 6.3, legacy revenue recognition guidance does not provide a single model for evaluating variable consideration. ASC 606, on the other hand, creates a single framework under which entities assess variable consideration in a contract with a customer to determine the amount to include in the transaction price.

In addition, under the legacy revenue recognition guidance, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. ASC 606 is less restrictive and requires an entity to include some or all of an estimate of variable (or contingent) consideration in the transaction price when the entity concludes that it is probable that changes in the 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.

Both of these changes to the revenue recognition guidance will also change the accounting for contingent consideration in transactions involving a sale or transfer of nonfinancial and in-substance nonfinancial assets to a noncustomer.

Example 3 in ASC 610-20, which is reproduced below, illustrates how an entity would account for a sale of a nonfinancial asset in exchange for variable consideration.
Example 3 — Sale of a Nonfinancial Asset for Variable Consideration

55-17 An entity sells (that is, does not out license) 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 entity concludes that the transferred in-process research and development is not a business. 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.

55-18 Topic 350 on goodwill and other intangibles requires the entity to apply the guidance in this Subtopic to determine the amount and timing of income to be recognized. Therefore, the entity applies the derecognition guidance in this Subtopic as follows:

a. The entity concludes that it does not have a controlling financial interest in the buyer.

b. The entity concludes that the contract meets the criteria in paragraph 606-10-25-1.

c. 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. This is because 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.

d. 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.

55-19 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.
18.4.2.3 Like-Kind Exchanges of Nonfinancial Assets

Entities may also enter into like-kind exchanges in which a nonfinancial asset owned by one entity is exchanged for a nonfinancial asset owned by another entity. These types of transactions may include the exchange of real estate and are typically structured for tax purposes. Under the new revenue standard, a nonmonetary exchange of a nonfinancial asset is accounted for as a sale of the nonfinancial asset for noncash consideration (i.e., the nonfinancial asset 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 nonfinancial asset), the entity would measure the noncash consideration received in the transaction at fair value. The entity would recognize a gain or loss on the sale and record the acquired nonmonetary consideration (i.e., the nonfinancial asset received) at its fair value. Further, ASU 2017-05 eliminates the guidance in ASC 845 on exchanges of nonfinancial assets for a noncontrolling interest. As a result, if the derecognition criteria are met (see Section 18.4.1), the noncontrolling interest received in connection with the partial sale is measured at fair value and included in the transaction price (see Section 18.5 below).

However, the entity would continue to apply the legacy guidance on nonmonetary exchanges in ASC 845 if the exchange is between entities in the same line of business to help facilitate sales to potential customers.

18.5 Exchanges of Nonfinancial Assets for Noncontrolling Interests

ASC 610-20-15-4(g) states that nonmonetary transactions within the scope of ASC 845 are excluded from the scope of ASC 610-20. Before adopting ASC 610-20, an entity would apply the guidance in ASC 845-10 (specifically, ASC 845-10-30-26) to account for an exchange of a nonfinancial asset for a noncontrolling ownership interest in an investee. However, ASU 2017-05 amends ASC 845-10 to remove the guidance on exchanges of nonfinancial assets for noncontrolling ownership interests in investees. Specifically, ASU 2017-05 amends ASC 845-10-15-4(k) as follows (added text is underlined, and deleted text is struck out):

The guidance in the Nonmonetary Transactions Topic does not apply to the following transactions: . . .

k. The transfer of a nonfinancial asset within the scope of Subtopic 610-20 in exchange for noncash consideration (see paragraph 610-20-32-1 paragraphs 610-20-32-2 through 32-3 which requires measurement consistent with paragraphs 606-10-32-21 through 32-24). However, if the noncash consideration promised in exchange for the nonfinancial asset is a noncontrolling ownership interest, that transaction is within the scope of this Topic.

As a result, once an entity has adopted ASC 610-20, it should apply the guidance in ASC 610-20 (which includes the amendments in ASU 2017-05) rather than ASC 845-10 to account for the contribution of a nonfinancial asset in exchange for a noncontrolling ownership interest in an investee.

In accordance with ASC 610-20-32-4, “the entity shall consider the noncontrolling interest received from the counterparty as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24.” In a manner consistent with the guidance in ASC 606-10-32-21 through 32-24, the entity would measure the noncontrolling interest at fair value at contract inception. Any gain or loss resulting from the sale or transfer of the nonfinancial asset should be recognized when the legal entity receiving the nonfinancial asset obtains control of the asset (as determined on the basis of an evaluation of the indicators in ASC 606-10-25-30). For additional information about recognizing gains or losses on the sale (or contribution) of nonfinancial assets, see Section 18.4.

4 As noted in Section 6.5, ASU 2016-12 clarifies that the measurement date for noncash consideration is the contract inception date.
Changing Lanes — Scope of Real Estate Contributions to a Joint Venture

Under the legacy guidance in ASC 970-323, an investor generally records 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, under the legacy guidance, if the transaction is an in-substance sale, it would be accounted for in accordance with ASC 360-20. In issuing ASU 2014-09, the FASB initially retained the guidance in ASC 970-323, which addressed partial sales of real estate assets that are contributed to a joint venture. However, the new guidance in ASC 610-20 originally did not adequately address partial sales transactions other than those within the scope of ASC 970-323 and raised several scope-related questions. Consequently, the FASB subsequently amended its guidance in ASC 610-20 by issuing ASU 2017-05, which clarifies the accounting for partial sales transactions and amends the guidance in ASC 970-323 to align it with the requirements of ASC 606 and 610-20. As a result, all transfers of real estate in exchange for a noncontrolling interest in another entity are accounted for in accordance with ASC 610-20.

Example 18-5

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. Since the real estate is neither a business nor a nonprofit activity, the transaction is within the scope of ASC 610-20. First, B considers whether, after the transaction, it retains a controlling interest in the joint venture under ASC 810 and concludes that it does not. Next, B determines that control of the real estate has been transferred under ASC 606. Accordingly, B derecognizes the real estate, recognizes the full gain or loss for the difference between the consideration received (i.e., both the cash consideration and the fair value of the 50 percent interest in the venture) and the carrying amount of the assets sold, and records its investment in the real estate venture at fair value.

18.6 Effective Date and Transition

The effective date of ASU 2017-05 is aligned with the requirements in the new revenue standard (see Chapter 16). If an entity decides to early adopt the guidance in ASU 2017-05, it must also early adopt ASC 606 (and vice versa).

Like the new revenue standard, ASU 2017-05 allows an entity to use a full or modified retrospective adoption method. The entity can also elect to apply (1) different adoption approaches for ASC 610-20 and ASC 606 (e.g., modified retrospective for ASC 610-20 and full retrospective for ASC 606) and (2) practical expedients for contracts within the scope of ASC 610-20 that are different from those for contracts within the scope of ASC 606.

Questions may arise about how transactions within the scope of ASC 610-20 in which the reporting entity retains a noncontrolling financial interest should be viewed for the purposes of applying the modified retrospective transition method when the entity elects to apply the guidance only to contracts that are not completed as of the date of initial application. We believe that the determination of “complete” under ASC 610-20 is closely aligned with the definition of a completed contract in ASC 606. That is, the entity must evaluate whether all or substantially all of the “revenue” (i.e., a gain or loss in the case of a transaction within the scope of ASC 610-20) was recognized before the initial adoption of the guidance in ASC 610-20. If all or part of the gain is deferred, the contract may not be considered a completed contract.
Connecting the Dots — Clarified Definition of a Completed Contract

ASU 2014-09 indicated that an entity’s contract with a customer is considered completed if the entity has transferred all of the goods or services identified in accordance with legacy U.S. GAAP (i.e., the entity’s performance under the contract has been completed). However, as a result of questions raised by stakeholders, the FASB decided to issue ASU 2016-12, which includes amendments to the new revenue standard’s definition of a completed contract. In ASU 2016-12, a completed contract is defined as “a contract for which all (or substantially all) of the revenue was recognized” in accordance with legacy U.S. GAAP. However, the clarified definition of a completed contract does not translate perfectly into transactions within the scope of ASC 610-20 since derecognition of nonfinancial (or in-substance nonfinancial) assets results in loss or gain recognition rather than in recognition of revenue. Nonetheless, the principle of what is deemed a completed contract in accordance with the transition provisions of ASC 606 can be applied to transactions within the scope of ASC 610-20.

Cases A and B in Example 18-6 below illustrate how an entity should determine whether a contract is not completed for purposes of applying ASC 610-20. Note that each case assumes that the entity adopted the guidance in ASU 2017-05 on January 1, 2018, and elected to apply the modified retrospective method to contracts that were not completed as of January 1, 2018. However, if an entity elects to apply the full retrospective method, all past transactions would be recast to comply with the new guidance and may therefore result in the recognition of a gain or loss earlier or later depending on the specific facts and circumstances.

Example 18-6

Case A — Contract Is Not Completed

Subsidiary B, a wholly owned subsidiary of Entity A, owns and operates a power plant. Since the power plant is the only asset held by B and is considered to be affixed to the land (i.e., it cannot be removed and used separately without incurring significant cost), the power plant is deemed to be in-substance real estate in accordance with ASC 360-20-15-2.

In 2017, A sells a 60 percent interest in B, whose cost basis is $100 million, to Entity C for $70 million. After the sale, A no longer controls B.

Although A retains a 40 percent interest in B, C is entitled to a preference in allocation of profits and distribution of cash flows. Since proceeds from the sale, including receivables from C, do not exceed all of A’s costs related to the entire property, ASC 360-20-40-49 precludes A from recognizing a gain associated with the sale of the controlling interest in B. Accordingly, the $10 million gain associated with A’s sale of its 60 percent interest in B ($70 million – [$100 million × 60%]) is deferred.

For the purposes of applying the transition guidance, the contract is not considered a completed contract (i.e., all or substantially all of the gain or loss was not recognized before the initial application of ASU 2017-05 on January 1, 2018). Accordingly, a cumulative adjustment is made to reflect the accounting for the contracts under the new guidance as of the date of initial application (i.e., January 1, 2018). Any resulting difference between the balances as of December 31, 2017, and the balances as of January 1, 2018 (i.e., an adjustment to the retained interest or equity investment balance), is recorded as an adjustment to beginning retained earnings as of January 1, 2018.
Example 18-6 (continued)

It is important to note that since A's contract with C is not deemed to be a completed contract, the accounting in this scenario is the same as if A had applied the full retrospective or modified retrospective approach to all contracts in transition (i.e., A would adjust its financial statements to reflect the accounting as if it had always applied the guidance in ASC 610-20, as amended).

Case B — Contract Is Completed

Assume the same facts as in Case A, except that C is not entitled to a preference in allocation of profits and distribution of cash flows. In this scenario, A determines that all three criteria in ASC 360-20-40-46 are met; accordingly, A recognizes a full gain of $10 million (as calculated in Case A above) upon the sale of its controlling interest in B. For the purposes of applying the transition guidance, the contract in this scenario is considered a completed contract (i.e., all or substantially all of the gain or loss was recognized before the initial application of ASU 2017-05 on January 1, 2018). Therefore, no modification should be made at transition for this contract.

However, it is important to note that the accounting in this scenario would be different if A had applied the full retrospective or modified retrospective method to all contracts in transition since ASC 610-20 would require A to recognize a gain that reflects the sale of 100 percent of B and A's retention of a 40 percent noncontrolling interest in B measured at fair value. If A had elected to apply either the full retrospective method or the modified retrospective method to all contracts, it would adjust its financial statements to reflect the accounting as if it had always applied the guidance in ASC 610-20, as amended.

If the entity uses different transition methods for ASC 606 and ASC 610-20, it would need to provide the transition-method disclosures required by ASC 606 for each transition method elected and indicate the method it used to adopt ASC 610-20. Regardless of the transition method the entity elects, it should apply the definition of a business as amended by ASU 2017-01 (see the related Connecting the Dots in Section 18.2.1), under which a transaction that was previously considered a disposal of a business may be considered a disposal of an asset. ASU 2017-05 clarifies that in such instances, the amounts previously allocated to goodwill associated with the disposal should not be reinstated.
Chapter 19 — Tax Considerations

19.1 Background

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). On December 22, 2017, the president signed into law the tax legislation commonly known as the Tax Cuts and Jobs Act (TCJA), which significantly modified the IRC, including the rules for recognizing revenue under IRC Section 451(b). The TCJA provides for a general financial accounting ("book") conformity rule under which a taxpayer's gross income may be accelerated for U.S. federal income tax purposes to the extent that revenue is recognized in the taxpayer's applicable financial statements (commonly referred to as the "AFS income inclusion rule"), with certain exceptions. The AFS income inclusion rule also requires taxpayers to apply their financial accounting method of allocating the transaction price in a contract to each performance obligation if the contract provides for multiple performance obligations. Thus, the AFS income inclusion rule changes the timing of revenue recognition for U.S. federal income tax purposes, including the amounts recognized for each performance obligation.

1 H.R. 1/Public Law 115-97, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."
Entities will need to comply with the changes to revenue recognition under the TCJA regardless of the year in which ASC 606 is adopted. However, for entities whose year of adoption is 2019 or later, there is a heightened importance to analyze the changes made under ASC 606 in conjunction with the changes to revenue recognition under the TCJA. In addition, entities should evaluate other tax impacts of the TCJA and ASC 606, such as those related to financial reporting for income taxes, indirect taxes, foreign jurisdictions, and, potentially, transfer pricing.

19.2 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 to be 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 administrative 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.

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 (i.e., the services could be separated into multiple contracts).

Income from the sale of goods (or other property, such as real estate) is recognized in 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 a license of intangible property, revenue is generally recognized over the period in which the licensed property is used.

The TCJA modified the revenue recognition principles under U.S. federal income tax law to provide that while an accrual-basis taxpayer should recognize any item of gross income (or a portion thereof) when the first and second criteria are satisfied, these criteria should be treated as satisfied no later than when the item of gross income (or a portion thereof) is accounted for as revenue in the taxpayer’s applicable financial statements (i.e., the TCJA’s AFS income inclusion rule should be applied). In accordance with the TCJA, when a taxpayer applies the AFS income inclusion rule to a contract containing multiple performance obligations, each allocation of the transaction price to a performance obligation for tax accounting purposes should be equal to the amount allocated to that performance obligation in the taxpayer’s applicable financial statements. Compliance with the revenue recognition changes as a result

2 The joint explanatory statement of the conference committee that reconciled differences between the House and Senate versions of the tax legislation ultimately enacted as the TCJA indicates that IRC Section 451(b), as amended by the TCJA, “does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred. For example, the provision does not require the recharacterization of a transaction from sale to lease, or vice versa, to conform to how the transaction is reported in the taxpayer’s applicable financial statement. Similarly, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. As a further example, income from investments in corporations or partnerships that are accounted for under the equity method for financial reporting purposes will not result in the recognition of income for Federal income tax purposes until such time that the Federal income tax realization [event] has occurred.”
of the TCJA and proposed regulations issued thereunder by the IRS in September 2019 is considered to be a change in tax method of accounting that requires entities to take action to obtain approval from the IRS. For a discussion of the procedures for obtaining consent from the IRS for a change in tax method of accounting, see Section 19.10.

The U.S. federal income tax laws also include special rules related to the recognition of revenue from certain types of transactions (“special methods of accounting”), which may create differences between book and tax methods. Taxpayers may be exempted from applying the AFS income inclusion rule when using a special method of accounting under another provision of U.S. federal income tax law. For example, taxpayers are permitted under IRC Section 460 to defer a portion of revenue related to a long-term contract that is accounted for under a cost-based input method as long as 10 percent of the total estimated costs have not been incurred in that tax year.

The sections below highlight some of the new revenue recognition guidance and its potential impact on the accounting for income taxes.

19.3 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 or the other four step 1 criteria at contract inception, the entity will not recognize revenue until (1) it meets the step 1 criteria or (2) amounts received are nonrefundable and at least one of the following events has occurred:

- There are no remaining obligations to transfer goods or services, and substantially all of the consideration has been received.
- The contract is terminated or canceled.
- 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 three events above 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

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3 A taxpayer may rely on the proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer applies all applicable rules contained therein.
be different from the “probable” collectibility threshold under the new revenue standard, resulting in earlier recognition for tax purposes than for financial reporting purposes. That is, 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, potentially resulting in recognition of a temporary difference between taxable income and book income.

**Connecting the Dots — Tax Implications of Reassessing the Criteria for Identifying a Contract (Example 4 in ASC 606-10-55-106 Through 55-109)**

In Example 4 of ASC 606 (reproduced in Section 4.5), 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. In a manner similar to that in the circumstances described above, a conclusion that revenue should continue to be recognized for tax purposes would potentially result in a temporary difference between taxable income and book income.

**19.4 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 as part of step 2 may result in a change in timing of the revenue recognized under the U.S. federal income tax laws.

Before the TCJA was enacted, the U.S. federal income tax rules generally required 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 needed to evaluate the potential for increased transactional taxes (or the ability to maintain existing billing systems). However, as discussed in Section 19.2, the TCJA modified the revenue recognition principles under U.S. federal income tax law and introduced the AFS income inclusion rule for contracts containing multiple performance obligations. When a taxpayer applies the AFS income inclusion rule to a contract containing multiple performance obligations, each allocation of the transaction price to a performance obligation for tax accounting purposes should be equal to the amount allocated to that performance obligation in the taxpayer’s financial statements. This modification may reduce the administrative burden of separately tracking the consideration of a contract containing multiple performance obligations for U.S. federal income tax and financial reporting purposes.

**Connecting the Dots — Tax Implications of Warranties (Example 44 in ASC 606-10-55-309 Through 55-315)**

The determination of 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 5.5.4), 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 legacy U.S. GAAP and the new revenue standard, 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 under IRC Section 451(c), as amended by the TCJA, and Proposed IRC Treasury Regulation (“Prop. IRC Treas. Reg.”) Section 1.451-8 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. Therefore, the deferred revenue related to the extended warranty under the new revenue standard will also be deferred in the initial year of receipt for tax purposes, and the remaining amount of the advance payment (i.e., the amount not recognized as service revenue in the first year) will be recognized in the next succeeding taxable year. Rev. Proc. 2019-37 provides procedural guidance for taxpayers on applying IRC Section 451(c) and Prop. IRC Treas. Reg. Section 1.451-8.

### 19.5 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.

Before the TCJA was enacted, variable or contingent revenue was not recognized under general U.S. federal tax principles until the amounts were fixed and determinable. Thus, a book-to-tax adjustment was required. One of the most significant changes of the TCJA was the modification of the revenue recognition principles under U.S. federal income tax law to provide that an accrual-basis taxpayer recognizes any item of gross income (or a portion thereof) when the amounts are fixed and determinable, but no later than when such item (or a portion thereof) is accounted for as revenue in the taxpayer’s applicable financial statements. The AFS income inclusion rule may cause many taxpayers to accelerate gross income related to variable or contingent revenue before the amounts are fixed and determinable because the new revenue standard requires an entity to recognize an estimate of the variable consideration (or a portion thereof) in a transaction unless certain conditions are met. However, there is uncertainty about whether the AFS income inclusion rule applies to all types of revenue streams.

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4 Both IRC Section 451(c) and Prop. IRC Treas. Reg. Section 1-451.8 are based largely on Revenue Procedure (“Rev. Proc.”) 2004-34. Note that until further guidance on the treatment of advance payments (e.g., final regulations) is applicable, a taxpayer may continue to rely on Rev. Proc. 2004-34.
In addition, stakeholders have raised questions about whether the cost of goods sold or deductions associated with estimates of variable consideration could also be accelerated when the related revenue is accelerated. These issues have yet to be addressed as of the date of this publication.

**Connecting the Dots — Tax Implications of a Volume Discount Incentive (Example 24 in ASC 606-10-55-216 Through 55-220)**

In Example 24 of ASC 606 (reproduced in Section 6.3.5.4.2), 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.

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 legacy 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 legacy 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.

**Connecting the Dots — Variable Consideration Involving Additional Consideration**

The volume discount incentive involves a reduction in the estimated total consideration to which the entity expects to be entitled under the contract. If, however, the variable consideration involves additional consideration under the contract, it is unclear whether the additional consideration would be recognized before the contingency is satisfied under the TCJA's AFS income inclusion rule for recognizing gross income. There is debate about whether the additional consideration is realized for U.S. federal income tax purposes, and thus required to be recognized, when there is an outstanding contingency.

19.6 **Step 4 — Allocate the Transaction Price to the Performance Obligations**

Before the TCJA was enacted, the allocation of the transaction price to multiple performance obligations in a contract potentially resulted in significant differences between book and tax treatment because the prior tax rules respected the form of the contract and required the transaction price to be allocated in accordance with the prices stated in the contract, whereas the new revenue standard requires the transaction price to be allocated to each performance obligation on a relative stand-alone selling price basis (subject to certain exceptions). However, the TCJA's AFS income inclusion rule may eliminate differences between book and tax treatment. As discussed in Section 19.2, the AFS income inclusion rule provides that when a taxpayer applies it to a contract containing multiple performance obligations, each allocation of the transaction price to a performance obligation for tax accounting purposes should be equal to the amount allocated to that performance obligation in the taxpayer's financial statements.
Connecting the Dots — Tax Implications of the Allocation Methodology (Example 33 in ASC 606-10-55-256 Through 55-258)

In Example 33 of ASC 606 (reproduced in Section 7.2), 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 in effect before the TCJA was enacted, 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 sold Product A and Product B in 20X8 and sold 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 ASC 606 for each of the two years ($33 for Product A plus $17 for Product B in 20X8, and $50 for Product C in 20X9).

Under the TCJA, however, the AFS income inclusion rule would respect the allocation method used under ASC 606. Therefore, the entity would allocate $33 to Product A, $17 to Product B, and $50 to Product C when determining the amount of revenue to be recognized for U.S. federal income tax purposes.

19.7 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 to be fixed at the earliest of when (1) payment is made, (2) payment is due, or (3) performance has occurred. As discussed in Section 19.2, the TCJA modified the revenue recognition principles under U.S. federal income tax law to provide that while an accrual-basis taxpayer should recognize any item of gross income (or a portion thereof) in the taxable year in which the right to the income becomes fixed and determinable, the fixed and determinable criteria should be treated as satisfied no later than when the item (or a portion thereof) is accounted for as revenue in the taxpayer’s financial statements (i.e., the AFS income inclusion rule should be applied). Accordingly, even if all events that would trigger revenue recognition for tax purposes occur after the criteria for revenue recognition are met for financial statement purposes, the taxpayer may still have to recognize revenue for tax purposes because the amounts are recognized for financial statement purposes earlier (subject to certain exceptions). Further, compliance with the AFS income inclusion rule is considered a change in method of accounting for U.S. federal income tax purposes that requires action by the taxpayer to obtain approval from the IRS.

A taxpayer that receives an advance payment for the future sale of goods or provision of services 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. For a taxpayer that recognizes and defers advance payment amounts in this manner, if revenue recognition is accelerated for financial reporting purposes under the new revenue standard (e.g., in the case of 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.
As previously noted, the tax laws also include special methods of accounting for revenue from certain types of transactions that may be excluded from the scope of the AFS income inclusion rule. For example, these special methods may require certain entities that enter into long-term construction or manufacturing contracts to report taxable income by using the percentage-of-completion method. Under the percentage-of-completion method, income is recognized in proportion to the costs incurred.

**Connecting the Dots — Tax Implications of Bill-and-Hold Arrangements (Example 63 in ASC 606-10-55-409 Through 55-413)**

Example 63 of ASC 606 (reproduced in Section 8.6.9) 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. Revenue is also recognized in 20X9 for tax purposes.

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 under ASC 606 (i.e., control was not transferred because the bill-and-hold criteria were not met) 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. In that scenario, consideration should be given to the special tax rules for advance payments to determine whether there is a book-to-tax adjustment.

19.8 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 IP’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 12 for further discussion of licensing transactions).

The tax rules in effect before the TCJA was enacted provided that revenue from the license of IP should be 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. Although the current tax rules likewise do not specifically draw a distinction between symbolic licenses (right to access IP) and functional licenses (right to use IP), the TCJA’s AFS income inclusion rule would effectively treat gross income from the two types of IP identified under the new revenue standard differently for U.S. federal income tax purposes. In accordance with the TCJA, the gross income from a functional license is accelerated while gross income from a symbolic license continues to be recognized over the period in which the licensed property is used, in a manner consistent with the treatment under the new revenue standard.

The TCJA does not change the character of the transaction. Therefore, an entity must still perform an analysis to determine whether a transaction is a license or a sale of IP for tax purposes.

**Connecting the Dots — Tax Implications of the Right to Use IP (Example 59 in ASC 606-10-55-389 Through 55-392)**

In Example 59 of ASC 606 (reproduced in Section 12.3.2), an entity licenses to a customer a right to use a recorded symphony in all commercials for two years in Country A. Under the new revenue standard, it is determined that the revenue from the license is recognized at a point in time.

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5 A taxpayer that receives an advance payment for the future sale of goods or provision of services 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.
Under the tax rules in effect before the TCJA was enacted, the revenue from licensing the right to use the recorded symphony would be recognized ratably over the two-year period instead of at the point in time at which the right to use the IP is granted. If a taxpayer received payment before providing the right to use (or access) a license, it would need to consider the special methods of accounting for advance payments discussed in Section 19.7.

Under the TCJA’s AFS income inclusion rule, the gross income from the license of the right to use the recorded symphony would be recognized entirely in the taxable year in which the right to use the IP is granted.

19.9 Contract Costs

Under legacy U.S. GAAP, entities may analogize to the guidance in ASC 310-20 or ASC 605-20 and elect to capitalize and amortize certain contract costs, including costs of acquiring a contract (e.g., sales commissions). Upon adoption of ASU 2014-09, entities will be required to apply the guidance in ASC 340-40 (see Chapter 13). 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. This may result in a new book-to-tax adjustment.

Connecting the Dots — Tax Implications of Incremental Costs of Obtaining a Contract (Example 1 in ASC 340-40-55-2 Through 55-4)

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 13.2.1), 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.

19.10 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 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.

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. 2019-43. 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. 2019-43 are nonautomatic and therefore require the IRS’s review and affirmative consent.
A change in the tax method of accounting is generally effective as of the first day of the taxable year of the change. The change is generally 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 tax 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. For additional discussion of accounting for tax method changes, see Deloitte’s A Roadmap to Accounting for Income Taxes.

**Connecting the Dots — Change in Book Method of Accounting as a Result of Implementing the New Revenue Standard**

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.

If a 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, the taxpayer must secure consent from the IRS to use the new book method. If the taxpayer does not secure consent from the IRS to change its tax accounting method, it must maintain its current tax accounting method and keep additional records as a result. Further, the taxpayer may be at risk under IRS examination if the current tax accounting method does not comply with the AFS income inclusion rule added by the TCJA.

If the taxpayer changes its tax method of accounting without securing consent from the IRS, it may similarly 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 with respect to the item subject to the method change. 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. For a discussion of the procedures for changing certain tax accounting methods in the year in which the taxpayer adopts ASC 606, see Section 19.12.

**19.11 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.

### 19.12 IRS Response to ASU 2014-09

In June 2015, the IRS issued [Notice 2015-40](#) to request comments on how the new revenue 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.”

The IRS received few comments in response to Notice 2015-40. Among those received were comments that taxpayers might request multiple changes in accounting methods as a result of adopting the new revenue standard. The IRS subsequently issued [Notice 2017-17](#) in March 2017 to propose procedures for taxpayers to obtain consent of the IRS to change their method of accounting for recognizing income for federal income tax purposes when the change is a result of, or directly related to, the adoption of ASU 2014-09 and the change is made for the same taxable year as the year of adoption of ASU 2014-09 (defined as a “qualifying same-year method change”).

In May 2018, the IRS issued [Rev. Proc. 2018-29](#), which, as modified by [Rev. Proc. 2018-49](#), added new automatic method change procedures for taxpayers changing certain accounting methods as a result of adopting the new revenue standard. Specifically, Rev. Proc. 2018-29 modified [Rev. Proc. 2017-30](#) to provide procedures for obtaining automatic consent from the IRS commissioner to change to a method of accounting that uses the new revenue standard to do one or more of the following:

- Identify performance obligations.
- Allocate the transaction price to performance obligations.
- Consider performance obligations satisfied.

This accounting method change is limited to the taxable year in which the taxpayer adopts ASC 606, and the new method must otherwise be permissible for U.S. federal income tax purposes. However, Rev. Proc. 2018-29 is not intended to provide guidance on the TCJA’s amendments to IRC Section 451(b). Effectively, the revenue procedure applies to those taxpayers that adopted ASC 606 in taxable years before the enactment of the TCJA because of the uncertainty about the treatment of revenue under IRC Section 451(b) and (c).

- A taxpayer that “wants to change to a method of accounting that treats an item of gross income, or portion thereof, as meeting the all events test no later than when such item, or portion thereof, is taken into account as revenue in [the taxpayer’s applicable financial statement] under [IRC Section] 451(b)(1)(A).”
- A taxpayer that (1) “is not adopting the [new revenue standard] for the year of change” and (2) “wants to allocate the transaction price to performance obligations under [IRC Section] 451(b)(4).”

Subsequently, in September 2019, the IRS issued Rev. Proc. 2019-37, which modified Rev. Proc. 2018-29 (as modified by Rev. Proc. 2018-49 and Rev. Proc. 2018-60). Specifically, Rev. Proc. 2019-37 added new automatic method change procedures for taxpayers that are changing certain accounting methods to comply with IRC Section 451(b) and (c) and Prop. IRC Treas. Reg. Sections 1.451-3 and 1.451-8. Generally, taxpayers may implement the changes to comply with Prop. IRC Treas. Reg. Sections 1.451-3 and 1.451-8 either with a cumulative catch-up adjustment or on a cut-off basis. However, members of a consolidated group must implement all changes with respect to their intercompany transactions on a cut-off basis.

**Construction Ahead — Additional Developments**

The IRS is expected to issue additional guidance on the treatment of revenue under IRC Section 451(b) and (c). Such guidance may affect the analysis of the tax implications of adopting ASC 606.

### 19.13 Recording the Income Tax Effects Upon Adoption of ASC 606

As discussed in Section 16.2, an entity can elect to use either the full retrospective method or the modified retrospective method when transitioning to the new revenue standard.

If an entity chooses to adopt the new revenue standard by using the full retrospective method, it is required to retrospectively apply the new revenue standard to all periods presented under the general guidance in ASC 250 on a change in accounting principle (see Section 16.2.1 for further discussion).

ASC 250 states that the retrospective application of a change in accounting principle includes only the direct effects of the change. In addition, ASC 250 specifies that direct effects of a change in accounting principle include “any related income tax effects.” Therefore, if an entity adopts the new revenue standard by using the full retrospective method, it must (1) determine the direct effects that full retrospective application would have had on both its income tax provision and its related balance sheet accounts (e.g., deferred tax assets (DTAs) or deferred tax liabilities (DTLs)) in all prior periods presented and (2) show those amounts as part of its full retrospective application of the new standard.

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6 An entity will need to use judgment when determining whether a related income tax effect represents a direct effect of a change in accounting principle.
In addition, under either transition method, an entity is required to show the cumulative effect of the change in accounting principle (i.e., the cumulative effect of applying the new revenue standard) in the opening balance of retained earnings (as of the beginning of the earliest period presented under the full retrospective method, or as of the beginning of the first annual period in which the new revenue standard is applied under the modified retrospective method). When calculating the cumulative effect of adopting the new revenue standard, an entity must consider all direct effects of adoption, including the direct effects on the entity's income-tax-related accounts (e.g., DTAs and DTLs). That is, if, as a result of adopting the new revenue standard, an entity is required to recognize new (or adjust existing) DTAs or DTLs, the entity should include the changes in those balances in its determination of the cumulative effect of the change in accounting principle. In accordance with ASC 740-20-45-11(a), an entity should recognize the offsetting tax adjustment in the opening balance of retained earnings along with the other (i.e., non-income-tax-related) cumulative effects of the change in accounting principle.

**Example 19-1**

**Income Tax Effects of Adopting the New Revenue Standard Under the Full Retrospective Method**

Entity A, a telecommunications company, sells mobile devices (e.g., tablets, handsets) and wireless services (i.e., voice and data services) to its customers. Entity A's standard contracts require its customer to purchase a mobile device and sign up for a non-cancelable contract for two years of wireless services. However, A does not charge the customer for the mobile device (i.e., the only price the customer pays is the monthly fee of $100 for the wireless services). Entity A accounts for the mobile device and voice and data services as separate units of accounting under ASC 605-25. However, none of the consideration promised under the contract is allocated to the mobile device because the consideration is contingent on A's providing the monthly wireless services. Accordingly, before adoption of ASC 606, A recognizes revenue from its contracts over the two-year service period. In addition, A has historically deferred the cost of the mobile device and amortized it over the two-year service period.

Entity A has concluded that under ASC 606, the mobile device and the wireless services will represent separate performance obligations. Therefore, A will allocate the transaction price (which is determined on the basis of the two-year non-cancelable contract) to both the mobile device and the wireless services on the basis of their relative stand-alone selling prices (i.e., ASC 606 eliminates the restriction on allocating a portion of the conditional consideration to the mobile device). The portion of the transaction price that is allocated to the mobile device will be recognized upon delivery of the device to the customer at contract inception, and the portion that is allocated to the wireless services will be recognized over the two-year service period. Entity A has determined that the stand-alone selling prices of the mobile device and wireless services are $600 and $2,400, respectively. In addition, A has concluded that it will recognize the cost of the mobile device upon delivery of the device to the customer.

On January 1, 2018, A adopts the new revenue standard by using the full retrospective method. Therefore, A will retrospectively apply the new revenue standard to each of the prior years presented (i.e., fiscal years 2017 and 2016) when it issues its financial statements in the year of adoption. Entity A has concluded that the amount of both revenue and costs recognized in the prior periods as a result of applying ASC 606 will be different from the amounts originally reported.

When A adopts the new revenue standard by using the full retrospective method, it must (1) determine the related income tax effects of the direct effects of applying the new revenue standard (including identifying new, or changes to existing, temporary differences [e.g., DTAs or DTLs] in all prior periods presented) and (2) show those amounts as part of its full retrospective application of the new standard.
Example 19-1 (continued)

Assume that A originally reported the following amounts in its 2017 and 2016 income statements by applying the guidance in ASC 605 (amounts in thousands):

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$2,500</td>
<td>$2,000</td>
</tr>
<tr>
<td>Cost of goods and services sold</td>
<td>1,500</td>
<td>1,200</td>
</tr>
<tr>
<td>Gross margin</td>
<td>1,000</td>
<td>800</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>400</td>
<td>150</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>600</td>
<td>650</td>
</tr>
<tr>
<td>Income taxes</td>
<td>240</td>
<td>260</td>
</tr>
<tr>
<td>Net income</td>
<td>360</td>
<td>390</td>
</tr>
</tbody>
</table>

Entity A determines that under the new revenue standard, it would have reported total revenue of $3,725 for 2017 and $3,000 for 2016. The primary reason for the increased revenue is that A would have recognized a portion of the transaction price for device sales that occurred in each period. In addition, A determines that under the new revenue standard, it would have reported the total cost of goods and services sold as $2,500 for 2017 and $2,000 for 2016. The primary reason for the increase in costs is that instead of amortizing the cost of the device over the service period, A would have recognized the total cost of the device in the year the device was sold.

Further, A determines that if it had applied the new revenue standard instead of ASC 605 to its income statements, its pretax income would have been $225 higher in 2017 and $200 higher in 2016. Therefore, A's income tax expense would also have been higher in 2017 and 2016, by an amount equal to the increase in pretax income multiplied by A's tax rate of 40 percent. Accordingly, A would also reflect the change in its income tax expense in the prior periods as part of applying the new revenue standard retrospectively to the prior periods, as shown in the following table:

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>As Reported</td>
<td>As Adjusted</td>
</tr>
<tr>
<td>Revenue</td>
<td>$2,500</td>
<td>$3,725</td>
</tr>
<tr>
<td>Cost of goods and services sold</td>
<td>1,500</td>
<td>2,500</td>
</tr>
<tr>
<td>Gross margin</td>
<td>1,000</td>
<td>1,225</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>600</td>
<td>825</td>
</tr>
<tr>
<td>Income taxes</td>
<td>240</td>
<td>330</td>
</tr>
<tr>
<td>Net income</td>
<td>360</td>
<td>495</td>
</tr>
</tbody>
</table>

As part of retrospectively restating its financial statements for 2017 and 2016, A would also have to recognize any new DTAs or DTLs, or changes in such amounts, that result from the changes noted above. Also note that current tax expense would not change in any period. That is, only deferred tax expense would change as a result of the adoption of ASC 606.
Example 19-2

Income Tax Effects of Adopting the New Revenue Standard Under the Modified Retrospective Method (With Election to Apply the Standard Only to Contracts Not Completed as of Date of Initial Application)

Assume the same facts as in Example 19-1, except that A adopts the new revenue standard by using the modified retrospective method and elects to apply the new revenue standard only to contracts that are not completed as of the date of initial application. Therefore, A calculates the cumulative effect of adopting the new revenue standard as of the initial date of application (January 1, 2018) on the basis of the impact of the new revenue standard's application on contracts that were not completed as of January 1, 2018.

Further assume that on January 1, 2018, A had two contracts with customers that were not substantially completed. As of the implementation date, A's contract position under legacy U.S. GAAP is recorded as follows:

<table>
<thead>
<tr>
<th>Contract 1</th>
<th>Contract 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract start date</td>
<td>November 1, 2017</td>
</tr>
<tr>
<td>Total transaction price</td>
<td>$2,400</td>
</tr>
<tr>
<td>Transaction price allocated to mobile device</td>
<td>—</td>
</tr>
<tr>
<td>Transaction price allocated to wireless services</td>
<td>2,400</td>
</tr>
<tr>
<td>Revenue recognized for mobile device</td>
<td>—</td>
</tr>
<tr>
<td>Revenue recognized for wireless services</td>
<td>200</td>
</tr>
<tr>
<td>Total revenue recognized</td>
<td>200</td>
</tr>
<tr>
<td>Total cost of mobile device</td>
<td>240</td>
</tr>
<tr>
<td>Cost of mobile device recognized</td>
<td>20</td>
</tr>
</tbody>
</table>

To calculate the cumulative effect of adopting the new revenue standard, A determines how both contracts above would have been accounted for had the new revenue standard been in place when they were entered into, as shown in the following table:

<table>
<thead>
<tr>
<th>Contract 1</th>
<th>Contract 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total transaction price</td>
<td>$2,400</td>
</tr>
<tr>
<td>Transaction price allocated to mobile device</td>
<td>480</td>
</tr>
<tr>
<td>Transaction price allocated to wireless services</td>
<td>1,920</td>
</tr>
<tr>
<td>Revenue recognized for mobile device</td>
<td>480</td>
</tr>
<tr>
<td>Revenue recognized for wireless services</td>
<td>160</td>
</tr>
<tr>
<td>Total revenue recognized</td>
<td>640</td>
</tr>
<tr>
<td>Contract asset balance (unbilled receivable)</td>
<td>440</td>
</tr>
<tr>
<td>Cost of mobile device recognized</td>
<td>240</td>
</tr>
</tbody>
</table>
Example 19-2 (continued)

On the basis of the analysis above, A concludes that upon adopting ASC 606 and before considering the income tax effects, it must record a cumulative-effect adjustment of $340. That adjustment is equal to the difference between the amount of revenue and cost that would have been reported under ASC 606 and the amount originally reported, as shown in the following table:

<table>
<thead>
<tr>
<th></th>
<th>ASC 605</th>
<th>ASC 606</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue recognized</td>
<td>$ 1,400</td>
<td>$ 2,080</td>
<td>$ 680</td>
</tr>
<tr>
<td>Total cost recognized</td>
<td>140</td>
<td>480</td>
<td>340</td>
</tr>
<tr>
<td>Total cumulative-effect adjustment</td>
<td></td>
<td></td>
<td>340</td>
</tr>
</tbody>
</table>

In addition, A has historically used its book method of accounting (which is assumed to be a permissible method) to determine its revenue and deductions for income tax purposes. Upon adopting ASC 606, A filed a Form 3115 with the IRS to change its tax method of accounting to a method that conforms with the new accounting principles adopted for book purposes (i.e., ASC 606). Assume that the change would be to another permissible method and would be automatically granted by the IRS. To determine how to account for the change in its tax method of accounting, A is required to calculate the difference between its taxable income under the new method and its taxable income under the old method. Because the change in tax accounting method was from one acceptable book method to another acceptable book method, the impact of the change on A’s taxable income is calculated in the same way as the cumulative-effect adjustment of adopting the new revenue standard for financial reporting purposes, which is illustrated above. Accordingly, A determines that its taxable income would have been $340 greater had it always used the new method of accounting (i.e., ASC 606) for tax purposes. If A’s tax rate is 40 percent, A would have owed an additional $136 in income taxes under the new method of accounting. Therefore, because A’s taxable income increased as a result of the change, it recognizes the $136 income tax impact. Thus, upon adopting the new revenue standard, A would also record the following journal entry as part of its cumulative-effect adjustment to its opening balance of retained earnings:

| Retained earnings | 136   |
| DTL — IRC Section 481(a) adjustment | 136   |
Chapter 20 — SEC, FASB, and Other Stakeholder Activities

20.1 Introduction

Since the issuance of ASU 2014-09, the FASB has issued additional final ASUs to (1) defer the new revenue standard's original effective date, (2) make certain technical corrections and improvements to the standard, (3) clarify certain aspects of the standard's guidance, and (4) codify or rescind certain SEC guidance on revenue. In addition, there has been significant activity by the 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. 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.

20.2 SEC Activities

20.2.1 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 legacy revenue recognition guidance originated in SAB 101 and SAB 104, which are now included in SAB Topic 13.

On August 18, 2017, the SEC staff issued SAB 116, which conforms existing SEC staff guidance with the guidance in ASC 606. As further discussed below, SAB 116 modifies (1) SAB Topic 13 on revenue recognition, (2) SAB Topic 8 on retail companies, and (3) SAB Topic 11.A on the disclosure of operating-differential subsidies.
In addition, the SEC updated its interpretive guidance on bill-and-hold arrangements and vaccine stockpiles.

### 20.2.1.1 SAB 116 Modifications to Previously Issued SEC Staff Guidance

SAB 116 modifies previously issued SEC staff guidance as follows:

- **SAB Topic 13** — In accordance with SAB 116, SAB Topic 13 will no longer be applicable when an SEC registrant adopts ASC 606. SAB Topic 13 provides the SEC staff's views on general revenue recognition guidance as codified in ASC 605. SAB 116 notes that ASC 606 "provides a single set of revenue recognition principles governing all contracts with customers and supersedes the existing revenue recognition framework in [ASC 605], which eliminates the need for [SAB] Topic 13." SAB 116 also states that upon adoption of ASC 606, "a registrant should no longer look to the guidance in Securities Exchange Act Release No. 23507 and Accounting and Auditing Enforcement Release No. 108 . . . for criteria to be met in order to recognize revenue" on a bill-and-hold basis.

  SEC registrants should note that the bill-and-hold guidance in SAB Topic 13 (which is applicable until the adoption of ASC 606) is more detailed than the bill-and-hold guidance in ASC 606. The most noticeable distinction is that SAB Topic 13 requires bill-and-hold arrangements to include a fixed delivery schedule, whereas ASC 606 does not include this requirement.

- **SAB Topic 8** — In accordance with SAB 116, SAB Topic 8 will no longer be applicable upon a registrant's adoption of ASC 606. SAB 116 notes that SAB Topic 8, which was specific to retail companies, previously provided the SEC staff's views on "the prohibition of presenting sales of a leased or licensed department within a retailer's statement of comprehensive income consistent with the principles codified [in ASC 605]" and "the disclosure of finance charges imposed by retailers on credit sales." SAB 116 further states that the guidance in ASC 606 on the identification of performance obligations in a contract with a customer, the presentation of revenue as a principal (on a gross basis) or as an agent (on a net basis), and the presentation of the effects of financing in the statement of comprehensive income “eliminates the need for the guidance in [SAB] Topic 8.”

- **SAB Topic 11.A** — SAB 116 modifies SAB Topic 11.A to clarify that “revenues from operating-differential subsidies presented under a revenue caption should be presented separately from revenue from contracts with customers accounted for under [ASC 606].” Previously, as noted in SAB 116, SAB Topic 11.A “provided the [SEC] staff's view that revenues from operating-differential subsidies be presented as a separate line item in the income statement either under a revenue caption or as credit in the costs and expenses section.”

The guidance in SAB 116 is applicable when an SEC registrant adopts ASC 606. Before a registrant adopts ASC 606, previously issued SEC staff guidance on revenue recognition remains applicable.

On November 22, 2017, the FASB issued ASU 2017-14, which rescinds certain SEC staff guidance in light of SAB 116. For additional information about ASU 2017-14, see Section 20.3.3.8.
20.2.1.2  Guidance on Recognizing Revenue From Vaccines Placed in a Federal Government Stockpile

On August 18, 2017, the SEC issued an interpretive release (the “2017 release”) to update the guidance in its 2005 release Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement Into the Pediatric Vaccine Stockpile or the Strategic National Stockpile. The 2017 release states that upon adoption of ASC 606, manufacturers should recognize revenue from vaccines placed in the “Vaccines for Children Program” and the “Strategic National Stockpile” because control of the enumerated vaccines will have been transferred to the customer when the vaccines are placed in the federal government stockpile program. The guidance in the 2017 release applies only to the vaccine stockpile programs discussed in that release and is not applicable to any other transactions.

On November 22, 2017, the FASB issued ASU 2017-14, which rescinds certain SEC guidance in legacy U.S. GAAP and codifies in ASC 606-10-S25-1 the text of the 2017 release. For additional information about ASU 2017-14, see Section 20.3.3.8.

20.2.1.3  Removal of Certain SEC Observer Comments

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 and ASU 2017-13. 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, we generally believe that it will remain appropriate to present shipping and handling within costs of goods sold because they are considered to be fulfillment costs. However, in certain instances, it may be acceptable for an entity to present shipping and handling outside of costs of goods sold. The presentation of shipping and handling costs was discussed by Barry Kanczuker, associate chief accountant in the SEC’s Office of the Chief Accountant (OCA), in a speech at the 2017 AICPA Conference on Current SEC and PCAOB Developments, in which he stated:

Given the noted absence of any guidance, I believe an entity will need to apply reasonable judgment in determining the appropriate classification of shipping and handling expenses for those shipping and handling activities that are accounted for as activities to fulfill the promise to transfer the good. Hence, the staff noted it would not object to the following approaches. First, the staff noted that it would not object to classification of these expenses within cost of sales. Second, given that there is no explicit guidance within Topic 606 related to the classification of shipping and handling expenses, the staff noted that it also would not object to an entity continuing to apply its previous policy regarding classification of these expenses, which could potentially be outside of cost of sales. I believe that a registrant that classifies significant shipping and handling costs outside of cost of sales should consider whether it should disclose the amount of such costs and the line item or items on the income statement that include them, similar to the disclosures required under the previous guidance.

See Sections 20.3.3.4 and 20.3.3.7 for further discussion of ASU 2016-11 and ASU 2017-13, respectively, which detail the rescission of certain SEC guidance.

20.2.2  SEC Reporting Considerations Related to the Adoption of the New Revenue Standard

The SEC staff has particularly focused on implementation issues related to compliance with certain SEC reporting requirements. These requirements include the inclusion, presentation, and disclosure of certain financial information.
20.2.2.1 SAB Topic 11.M Disclosures

The SEC staff has continued to emphasize 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”). 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. The staff has highlighted the importance of “timely investor education and engagement” and that in the past, 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 addition, the SEC staff has indicated that it expects to see more robust qualitative and quantitative disclosures about (1) the anticipated impact of the new revenue standard and (2) the status of management's progress in implementation as the adoption date of the new standard approaches.

The SEC staff has also reiterated the need to provide transparent transition disclosures that comply with the requirements of SAB Topic 11.M and has 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. For additional discussion of implementation disclosures, see Section 21.7.1.

20.2.2.2 Requirement for Revised Financial Statements — New or Amended Registration Statement

Form S-3, Item 11(b)(ii), requires registrants to provide revised financial statements in a new registration statement if there has been a material retrospective change in accounting principle.

If a registrant files a new or amended registration statement before it files the Form 10-Q in which its adoption of ASU 2014-09 is first reported, the registrant is not required (or permitted) to file updated financial statements for prior periods to reflect the ASU. However, the registrant should consult with its legal counsel and independent accountants regarding the appropriate disclosure to provide in the registration statement.

If a registrant elects to use the full retrospective method of adoption and subsequently files a registration statement in Form S-3 that incorporates by reference interim financial statements reflecting the impact of the adoption of the new revenue standard, the registrant would be required to retrospectively revise its annual financial statements in its Form 10-K provided that the change in accounting principle is material. Those annual 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”). Filing the registration statement would also accelerate the timing related to when a registrant would be required to provide revised information for previously completed years.

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1 See SAB Topic 11.M.
2 This was announced by the SEC observer at the September 22, 2016, EITF meeting. Refer to Deloitte's September 22, 2016, Financial Reporting Alert for additional information about the SEC staff's comments on transition issues.
3 SEC registrants that file a proxy statement with the SEC should also refer to this guidance.
4 See the highlights of the June 2009 CAQ SEC Regulations Committee joint meeting with the SEC staff.
5 This guidance also applies to any new or amended registration statement other than Form S-8 that is filed after a registrant files a Form 10-Q that reports the material retrospective change.
These concepts are illustrated in the example below.

Example 20-1

A registrant with a September 30 year-end adopts the new revenue standard on October 1, 2018, by using the full retrospective method and files its first-quarter Form 10-Q on February 1, 2019. If the retrospective change in accounting principle is material and the registrant files a Form S-3 on March 1, 2019, it is required under Form S-3, Item 11(b)(ii), to revise its previously filed annual financial statements retrospectively for the years ending September 30 of 2018, 2017, and 2016, respectively, since financial statements for these years are required in the registration statement. If the registrant did not file a registration statement, it would only be required to revise the two most recent prior comparative periods, 2018 and 2017, when it files its September 30, 2019, Form 10-K.

If the registrant files a Form S-3 on December 15, 2018, before its first-quarter Form 10-Q, the registrant is not required (or permitted) to file updated financial statements for prior periods to reflect the application of ASU 2014-09. However, the registrant should consult with its legal counsel and independent accountants regarding the appropriate disclosure to provide in the registration statement.

At the 2016 AICPA Conference on Current SEC and PCAOB Developments, the staff of the SEC's Division of Corporation Finance recognized preparers' concerns about the fourth year and reiterated that there are no plans to modify the form requirements. Therefore, when adopting the new revenue standard, an entity may look to the guidance in other U.S. GAAP or IFRS Standards on the adoption of new accounting standards and contemplate the impracticability exception to retrospective application. The staff observed that the impracticability exception is a high hurdle and that companies may opt to consult the Office of the Chief Accountant regarding this topic.

If a registrant chooses to adopt the new revenue standard by using the modified retrospective method, only the most recent fiscal year would be presented under the new standard. Therefore, the requirements discussed above are not applicable under the modified retrospective method. However, a registrant that uses the modified retrospective method may wish to provide supplemental voluntary disclosures in its MD&A that discuss the effects of the adoption of the new revenue standard on prior years under the full retrospective method. Such supplemental MD&A disclosures, if presented, (1) should disclose the impact on each financial statement line item affected by such retrospective treatment (i.e., revenue and expense line items), (2) should disclose the assumptions that the registrant used in estimating the impact on the prior-year information presented (e.g., any practical expedients applied, date of adoption), and (3) should not present a full income statement under the full retrospective method but instead should focus only on disclosing the financial statement line items affected. Refer to Section 20.2.2.8 for further discussion of supplemental MD&A disclosures in the year of adoption.

For currently effective registration statements (e.g., an existing Form S-3), a registrant may use a prospectus supplement to draw down or issue securities. Paragraph 13110.2 of the FRM indicates that “a prospectus supplement used to update a delayed or continuous offering registered on Form S-3 (e.g., a shelf takedown) is not subject to the Item 11(b)(ii) updating requirements” (as discussed above). Paragraph 13110.2 states that instead, under SEC Regulation S-K, Item 512(a), “Registrants must update the prospectus . . . with respect to any fundamental change.”
At the 2016 AICPA Conference on Current SEC and PCAOB Developments, the staff of the SEC's Division of Corporation Finance clarified that it is the responsibility of management, in consultation with legal counsel, to determine whether the adoption of the new revenue standard constitutes a fundamental change. In this regard, the staff stated that it would be “surprised” if management concluded that the adoption of the new revenue standard resulted in a fundamental change and could not see “circumstances under which the staff would challenge management’s assessment of a non-fundamental change on that point.”

20.2.2.3 Requirement for Selected Financial Data

SEC 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”).

However, as noted in paragraph 11110.1 of the FRM, 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.


On January 30, 2020, the SEC issued a proposed rule that would modernize and simplify MD&A as well as certain financial disclosure requirements in SEC Regulation S-K. Among other changes, the proposal would eliminate Regulation S-K, Item 301, “Selected Financial Data” (i.e., the five-year table).

For more information about this proposed rule, see Deloitte’s February 10, 2020, Heads Up.

20.2.2.4 SEC Regulation S-X, Rules 3-09 and 4-08(g) — Financial Statements and Summarized Financial Information for Equity Method Investments

Under SEC 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 SEC 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.\

The SEC staff has further clarified in **paragraph 11120.2** 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.

### 20.2.2.5 Permissibility of Non-PBE Adoption Dates for Other Entities’ Financial Statements or Financial Information Required in a Registrant’s Filings

At the July 20, 2017, EITF **meeting**, the SEC staff provided significant relief to registrants that are required to include financial statements or financial information of other entities in their SEC filings. Specifically, the SEC staff announced that it would not object to elections by certain public business entities (PBEs) (referred to herein as “specified PBEs”) to use the non-PBE effective dates for the sole purpose of adopting the FASB’s new standards on revenue and leases.

The principal beneficiaries of the relief will be SEC registrants that include financial statements or financial information prepared by specified PBEs in their own filings, for example, under the following SEC Regulation S-X rules:

- Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired.”
- Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”
- Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired.”
- Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”

On September 29, 2017, the FASB issued **ASU 2017-13**, which amends the transition guidance in ASC 606-10-65 to include the SEC staff announcement issued at the July 20, 2017, EITF meeting. See **Sections 16.1.2** and **20.3.3.7** for additional information.

### 20.2.2.6 Pro Forma Financial Information Under Article 11

SEC 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. The objective of pro forma financial information is to enable investors to understand and evaluate the impact of a transaction, such as a business acquisition, by showing how that transaction might have affected the registrant’s historical financial position and results of operations had the transaction occurred at an earlier date. **Paragraph 3250.1(m)** of the FRM indicates that if a registrant adopts a new accounting

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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, see Deloitte’s *A Roadmap to Impairments and Disposals of Long-Lived Assets and Discontinued Operations*.

7 On May 20, 2020, the SEC issued a **final rule** that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. The final rule is effective for a registrant’s fiscal year beginning after December 31, 2020; however, early application is permitted. For more information about the final rule, see Deloitte’s June 2, 2020, *Heads Up*. 
standard as of a date, or under a transition method, different from that of the acquired or to be acquired business (the “acquiree”), the acquiree's date of adoption and transition method must be conformed to those of the registrant in the registrant's pro forma financial information. Accordingly, if the acquiree uses non-PBE adoption dates or has selected a transition method different from that of the registrant, the registrant must include pro forma adjustments to conform both the acquiree's adoption date and the acquiree's transition method to those of the registrant. The SEC staff has indicated that relief from this requirement would be considered in certain circumstances.

Article 11 generally requires pro forma financial information for the most recent fiscal year and subsequent interim period. In the year of adoption, a registrant that elects to use the full retrospective method and does not file retrospectively revised financial statements (see Section 20.2.2.2) will not be required to update previous annual periods until the filing of its Form 10-K for the year of adoption. Thus, if pro forma financial information is required during the year of adoption, the registrant's historical financial information for the most recent interim period would reflect the application of ASC 606; however, the most recent annual period would reflect the application of ASC 605 (since the prior year would not be revised until the filing of the next Form 10-K). Paragraph 3250.1(n) of the FRM indicates that a registrant is not required to apply new accounting policies, such as those related to the adoption of ASC 606, “to the pro forma information for periods prior to adoption until it has reflected the new standard in the historical financial statements for those periods.” Therefore, a registrant would not be required to accelerate the retrospective revision of prior annual periods to reflect the adoption of ASC 606 on a full retrospective basis solely for the preparation of pro forma financial information. However, as further indicated in paragraph 3250.1(n) of the FRM, if the effect of the adoption of ASC 606 on the prior-year historical information will be material, the registrant “should make appropriate disclosure to that effect in the notes to the pro forma financial information.”

Changing Lanes — Final Rule to Improve Disclosures for Business Acquisitions and Dispositions

On May 20, 2020, the SEC issued a final rule that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. The final rule is effective for a registrant's fiscal year beginning after December 31, 2020; however, early application is permitted. Regarding pro forma financial information, the final rule explicitly prohibits retrospective revisions stemming from the registrant's adoption of a new accounting standard until they are depicted in the registrant's historical financial statements.

For more information about this final rule, see Deloitte’s June 2, 2020, Heads Up.

20.2.2.7 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 SEC 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 21.5.
Non-GAAP Financial Measures

In response to increasing concerns about the use of non-GAAP measures, the SEC staff updated its Compliance and Disclosure Interpretations (C&DIs) in May 2016 to provide additional guidance on what it expects from registrants that use these measures. In Question 100.04 of its Non-GAAP Financial Measures C&DIs, 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.

At the 2016 AICPA Conference on Current SEC and PCAOB Developments, the staff of the SEC's Division of Corporation Finance noted the SEC staff's continuing dialogue with registrants on presentation of such measures. The staff acknowledged that there may be circumstances under which revenue can be adjusted and noted that it may be acceptable for a registrant to present measures that adjust revenue and expense if there are some very unique or unusual factors, such as a change in revenue model coupled with the anticipated impact of adopting the new revenue recognition guidance in ASC 606.

For more information, see Deloitte's A Roadmap to Non-GAAP Financial Measures and Metrics.

Connecting the Dots — Individually Tailored Accounting Principles

At the 2018 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed whether adjusting revenue to a pre-ASC 606 basis (i.e., ASC 605) after adoption of ASC 606 would be considered individually tailored accounting for companies that adopted the new revenue standard by using the modified retrospective method. ASC 606-10-65-1(i) specifies that in the year of initial application, entities that elect to use the modified retrospective method are required to disclose the effect of changes to financial statement line items resulting from the entities' application of the new standard (see Section 16.2.2).

This requirement may effectively result in the disclosure of affected line items on an “ASC 605 basis” for the year of adoption. Because the disclosures are required under GAAP, they generally would not be considered individually tailored accounting, or even non-GAAP measures, for the year of adoption. However, adjusting to present historical results under ASC 605 in periods after the initial period of adoption could be considered individually tailored accounting principles.

This view is consistent with one expressed at the March 2018 CAQ SEC Regulations Committee joint meeting with the SEC staff, which maintained that when a registrant's current-period results reflect the adoption of the new revenue standard under the modified retrospective method, the registrant may present, as a supplement in MD&A, a discussion that treats those results on an ASC 605 basis to provide comparability with prior periods. However, the discussion of the current results of operations under ASC 606 should be given prominence. Such disclosure should be included only in the period of adoption (e.g., 2018 only for calendar-year-end PBEs) and should be comparable with the disclosures provided in the financial statements under ASC 250.
20.2.2.9 Effects of Accounting Changes by a Successor Entity on Predecessor-Period Financial Statements

At the March 2017 CAQ SEC Regulations Committee joint meeting with the SEC staff (the “March 2017 CAQ meeting”), the committee and SEC staff discussed the effect on predecessor-period financial statements of accounting changes by a successor, specifically when the successor’s basis of accounting differs from that of its predecessor because of a change in control, pushdown accounting, or fresh-start reporting. For example, this situation would arise if a transaction that occurs on November 15, 2017, causes a change in basis requiring a successor/predecessor black-line presentation and the successor entity retrospectively adopts a new accounting standard effective January 1, 2018.

This matter is particularly important in light of the significance of the new revenue recognition standard and the lack of comparability if the registrant does not adjust the predecessor-period financial statements. As noted in the highlights of the March 2017 CAQ meeting, the SEC staff referred registrants to paragraph 13210.2 of the FRM, which, in the staff’s view, indicates that the need to reflect the impact of discontinued operations in predecessor periods “does not apply to any other accounting changes and therefore, has no bearing on the analysis.”

The committee and the SEC staff continued this discussion at their September 2017 joint meeting (the “September 2017 CAQ meeting”). As noted in the highlights of the September 2017 CAQ meeting, the SEC staff “observed that there is no US GAAP or other regulatory requirement to retrospectively adjust predecessor period financial statements for accounting changes by a successor entity.”

20.2.2.10 Transition Considerations for EGCs

Among other benefits, an emerging growth company (EGC) is not required to comply with new or revised accounting standards as of the effective dates for PBEs and may elect to take advantage of the extended transition provisions by using non-PBE (or private-company) adoption dates for as long as the issuer qualifies as an EGC. Therefore, a calendar-year-end EGC that elects to take advantage of the extended transition provisions and adopt the new revenue standard by using private-company adoption dates will generally apply the standard for either of the following periods:

- Annual periods beginning on January 1, 2019, and interim periods within annual periods beginning on January 1, 2020.
- Annual periods beginning on January 1, 2020, and interim periods within annual periods beginning on January 1, 2021, if the EGC’s financial statements were not issued or made available for issuance as of June 3, 2020.

See Chapter 16 for additional information about the effective date of ASC 606.

At the 2018 AICPA Conference on Current SEC and PCAOB Developments, Lindsay McCord, then deputy chief accountant of the SEC’s Division of Corporation Finance, addressed transition requirements related to the adoption of new accounting standards for EGCs that elect to take advantage of the extended transition provisions and defer adoption of a new or revised accounting standard by using non-PBE adoption dates. Ms. McCord indicated that if a registrant no longer qualifies as an EGC after the PBE adoption date for the new revenue standard (i.e., loses its EGC status after January 1, 2018, under the assumption that the registrant is a calendar-year-end entity) but before the non-PBE adoption date, the situations in which an EGC has not issued or made available for issuance its financial statements by June 3, 2020, are generally expected to be limited to when the entity is a new SEC registrant.

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8 Paragraph 13210.2 of the FRM requires predecessor financial statements to be retrospectively revised to reflect the impact of a successor’s discontinued operations.
9 For a discussion of the qualifications for EGC status and the accommodations applicable to EGCs, see Section 1.6 of Deloitte’s A Roadmap to Initial Public Offerings.
10 The situations in which an EGC has not issued or made available for issuance its financial statements by June 3, 2020, are generally expected to be limited to when the entity is a new SEC registrant.
the registrant can no longer delay the adoption of the new revenue standard by using the private-company adoption date (i.e., January 1, 2019, for a calendar-year-end entity [or January 1, 2020, if the EGC’s financial statements were not issued or made available for issuance as of June 3, 2020]). However, if a registrant adopted the new revenue standard before losing its EGC status, the SEC staff would not expect the registrant to revise its financial statements for an earlier adoption date.

In a manner consistent with Ms. McCord’s remarks, the examples below illustrate the application of the transition requirements to a registrant that adopted (or will adopt) ASC 606 by using the modified retrospective method.

**Example 20-2**

**Registrant Qualifies as an EGC on December 31, 2019**

Registrant B is a calendar-year-end EGC that has elected to take advantage of the extended transition provisions and adopt the new revenue standard by using private-company adoption dates. Registrant B will be required to adopt the new revenue standard for annual periods beginning on January 1, 2019, and for interim periods within annual periods beginning on January 1, 2020 (under the assumption that its financial statements are issued or made available for issuance before June 3, 2020), as follows:

- Registrant B will first adopt the new revenue standard in its 2019 annual financial statements included in its 2019 Form 10-K after reporting in accordance with ASC 605 in its 2019 quarterly reports on Form 10-Q.
- As paragraph 11110.2 of the FRM indicates, B is not required to reflect adoption of the new revenue standard in the selected quarterly financial data (SEC Regulation S-K, Item 302(a)) for the 2019 quarterly periods in its 2019 Form 10-K. However, the SEC staff would expect B to provide clear and transparent disclosures that the quarterly financial data in its 2019 Form 10-K are presented on a basis different from that of the annual financial statements presented in its 2019 Form 10-K.
- For quarterly financial information presented in B’s subsequent Forms 10-Q in 2020, the SEC staff would encourage, but not require, B to present the 2019 comparable quarters under the new revenue standard. If B does not present the 2019 comparable quarters under the new revenue standard, the SEC staff would expect B to provide clear and transparent disclosures that the prior-period information is presented on a basis different from that of the current year.

If B loses its EGC status (i.e., no longer qualifies as an EGC) on December 31, 2020 (or later), B would not be expected to revise its date of adoption of the new revenue standard since the new revenue standard was adopted before B lost its EGC status.

**Example 20-3**

**Registrant No Longer Qualifies as an EGC on December 31, 2019**

Assume the same facts as in Example 20-2, except that Registrant B no longer qualifies as an EGC on December 31, 2019. The SEC staff will not object if B adopts the new revenue standard only in its 2019 annual financial statements as follows:

- Registrant B may first adopt the new revenue standard in its 2019 annual financial statements included in its 2019 Form 10-K.
- Registrant B should reflect adoption of the new revenue standard in its selected quarterly financial data (SEC Regulation S-K, Item 302(a)) for the 2019 quarterly periods in its 2019 Form 10-K.
Example 20-3 (continued)


Although the SEC staff did not address whether a registrant should provide clear and transparent disclosures that the quarterly financial data presented in its 2019 Form 10-K do not mirror the information in its 2019 Forms 10-Q, we believe that a registrant should provide such disclosures when the adoption of the new standard is reflected in its selected quarterly financial data. In addition, we believe that for quarterly financial information presented in its subsequent Forms 10-Q in 2020, Registrant A in this example should present the 2019 comparable quarters under the new revenue standard.

Ms. McCord also indicated that a registrant that files an initial registration statement and does not qualify as an EGC must present financial statements that apply the PBE adoption dates for new accounting standards. Accordingly, for a calendar-year-end company, the financial statements must reflect the adoption of ASC 606 as of January 1, 2018.

**Connecting the Dots — IPO Considerations**

Non-EGC private entities may want to consider how their timeline for a potential IPO may affect their plans related to adopting the new revenue standard. For example, if a non-EGC calendar-year-end private entity elects to file an IPO after having adopted the new revenue standard on January 1, 2019 (the required adoption date for nonpublic entities if the entities' financial statements were issued or made available for issuance before June 3, 2020), the entity would be required to retrospectively adjust its financial statements and accelerate its adoption date to January 1, 2018, the required adoption date for PBEs.

In certain scenarios, an entity may lose its EGC status during the IPO process. Paragraph 10110.5 of the FRM states that a registrant may retain the EGC disclosure accommodations until the earlier of (1) the “date on which the issuer consummates its initial public offering” or (2) the “end of the one-year period beginning on the date the company ceased to be an EGC.” However, questions have arisen about how the adoption of new standards should be reflected in subsequent filings since the registrant would cease to qualify as an EGC upon consummation of the IPO. Paragraph 10230.1 of the FRM states that an issuer that adopts a standard after losing its EGC status should generally do so by using the PBE adoption dates in its next filing after losing status. The SEC staff encourages EGCs to (1) review their plans to adopt accounting standards upon the loss of EGC status and (2) consult with the Division of Corporation Finance if they do not believe that they will be able to comply on a timely basis with the requirement to reflect new accounting standards already effective for PBEs in their next periodic filing. For more information, refer to the highlights of the March 2019 CAQ SEC Regulations Committee joint meeting with the SEC staff.

**20.2.2.11 Interaction Between ASC 606 and SEC Regulation S-X, Rule 5-03(b)**

SEC Regulation S-X, Rule 5-03(b), indicates the various line items that should appear on the face of the income statement. Specifically, a registrant should separately present any amounts that represent 10 percent of the sum of income derived from net sales of tangible products, operating revenues of public utilities or others, income from rentals, revenues from services, and other revenues. Rule 5-03(b) has not been updated since the issuance of ASU 2014-09. Further, there is limited guidance on interpreting the requirements of Rule 5-03(b) — for example, the terms “income from rentals,” “revenues from services,” “products,” and “services” are not specifically defined. Despite the long-standing need for registrants to use judgment when applying Rule 5-03(b), stakeholders have raised concerns about the interplay between Rule 5-03(b) and new accounting standards, including the new revenue standard.
The interaction between ASC 606 and Rule 5-03(b) was discussed at the March 2018 CAQ SEC Regulations Committee joint meeting with the SEC staff. As indicated in the highlights of that meeting, the SEC staff noted that it is encouraging registrants to submit real-life examples of potential inconsistencies in income statement classification that may arise between ASC 606 and Rule 5-03(b). For additional information, see Deloitte's May 22, 2018, journal entry.

20.3 FASB Activities

20.3.1 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 could participate as observers. However, it is important for consistency and comparability of financial information that both domestic registrants filing under U.S. GAAP and foreign private issuers filing under IFRS Standards keep abreast of TRG developments in the United States in a manner consistent with comments made by then SEC Deputy Chief Accountant Wesley Bricker at the December 2015 AICPA Conference on Current SEC and PCAOB Developments.

At the November 2016 TRG meeting — the last TRG meeting to date — the FASB announced that no future TRG meetings were scheduled. However, the Board encouraged stakeholders to submit implementation questions either directly to the TRG or through the FASB’s technical inquiry process. Further, the Board indicated that the scheduling of any future TRG meetings would depend on issues identified by stakeholders (i.e., the identification of implementation issues that are significant and far reaching), partly because some entities would be early adopting the standard as of January 1, 2017.

The FASB maintains a full list of questions discussed by the TRG, with links to the relevant TRG Agenda Papers.

20.3.2 FASB Staff’s Revenue Recognition Implementation Q&As

In January 2020, the FASB issued its staff’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”). Compiled from TRG Agenda Papers and other previously issued materials, the FASB staff’s Implementation Q&As are presented in a user-friendly format.

For a topical listing of issues addressed in the Implementation Q&As, see Appendix C.

20.3.3 Final ASUs

As noted above, the FASB has issued a number of ASUs to amend and clarify the guidance in the new revenue standard. Largely the result of feedback provided by the TRG, the Board’s updates to the new revenue standard are discussed throughout this Roadmap as applicable.
20.3.3.1 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 PBEs, the standard became 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.

On June 3, 2020, the FASB issued ASU 2020-05 which permits nonpublic entities (i.e., entities that are not PBEs) that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, to adopt ASC 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. See Sections 16.1 and 20.3.3.12 for further details.

20.3.3.2 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.
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• 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.

20.3.3.3 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 5.2.4.3 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 12.4 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 12.7 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 12.3.2 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 12.6 for further details.

### 20.3.3.4 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.

### 20.3.3.5 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 4.3.5.3 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 6.7 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 6.5 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 16 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 historically 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 16 for further details.
20.3.3.6 ASU 2016-20 on Technical Corrections and Improvements

On December 21, 2016, the FASB issued ASU 2016-20, which amends certain aspects of ASU 2014-09 and includes technical corrections that are intended to clarify, rather than change, the new revenue standard’s core revenue recognition principles.

Key provisions of the amendments are summarized in the table below, which is reproduced from ASU 2016-20.

<table>
<thead>
<tr>
<th>Area for Correction or Improvement</th>
<th>Summary of Amendments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issue 1: Loan Guarantee Fees</strong></td>
<td>The amendments in this Update clarify that guarantee fees within the scope of Topic 460 (other than product or service warranties) are not within the scope of Topic 606. Entities should see Topic 815, Derivatives and Hedging, for guarantees accounted for as derivatives.</td>
</tr>
<tr>
<td>Topic 606 specifically identifies a scope exception for guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees. Stakeholders indicated that a few consequential amendments included in Update 2014-09 are inconsistent on whether fees from financial guarantees are within the scope of Topic 606.</td>
<td></td>
</tr>
</tbody>
</table>

**Issue 2: Contract Costs — Impairment Testing**

Subtopic 340-40, Other Assets and Deferred Costs — Contracts with Customers, includes impairment guidance for costs capitalized in accordance with the recognition provisions of that Subtopic. Stakeholders raised some questions about the impairment testing of those capitalized costs.

The amendments in this Update 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 it expects to receive in the future.

**Issue 3: Contract Costs — Interaction of Impairment Testing With Guidance in Other Topics**

Some stakeholders raised questions about the interaction of the impairment testing in Subtopic 340-40 with guidance in other Topics.

The amendments in this Update clarify that impairment testing first should be performed on assets not within the scope of Topic 340, Topic 350, Intangibles Goodwill and Other, or Topic 360, Property, Plant, and Equipment (such as Topic 330, Inventory), then assets within the scope of Topic 340, then asset groups and reporting units within the scope of Topic 360 and Topic 350.

**Issue 4: Provisions for Losses on Construction-Type and Production-Type Contracts**

When issuing Update 2014-09, the Board decided to exclude specific guidance in Topic 606 for onerous contracts. However, the Board decided to retain the guidance on the provision for loss contracts in Subtopic 605-35, Revenue Recognition — Construction-Type and Production-Type Contracts. In the consequential amendments of Update 2014-09, the testing level was changed to the performance obligation level (from the segment level). Stakeholders indicated that this amendment, in some circumstances, may require an entity to perform the loss assessment at a lower level than legacy practice.

The amendments in this Update require that the provision for losses be determined at least at the contract level. However, the amendments allow an entity to determine the provision for losses at the performance obligation level as an accounting policy election.
### Area for Correction or Improvement

<table>
<thead>
<tr>
<th>Issue 5: Scope of Topic 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Topic 606, a scope exception exists for insurance contracts within the scope of Topic 944, <em>Financial Services — Insurance</em>. The Board's intention was to exclude from Topic 606 all contracts that are within the scope of Topic 944, not only insurance contracts (for example, investment contracts that do not subject an insurance entity to insurance risk).</td>
</tr>
<tr>
<td>The amendments in this Update remove the term insurance from the scope exception to clarify that all contracts within the scope of Topic 944 are excluded from the scope of Topic 606.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issue 6: Disclosure of Remaining Performance Obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Topic 606 requires an entity to disclose information about its remaining performance obligations, including 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. Topic 606 also includes optional exemptions from that disclosure for contracts with an original duration of one year or less and performance obligations in which revenue is recognized in accordance with paragraph 606-10-55-18. Stakeholders questioned whether the Board intended for an entity to estimate variable consideration for disclosure in other circumstances in which an entity need not estimate variable consideration to recognize revenue.</td>
</tr>
<tr>
<td>The amendments in this Update provide optional exemptions from the disclosure requirement for remaining performance obligations for specific situations in which an entity need not estimate variable consideration to recognize revenue. The amendments in this Update also expand the information that is required to be disclosed when an entity applies one of the optional exemptions.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issue 7: Disclosure of Prior-Period Performance Obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Topic 606 requires an entity to disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods. Stakeholders indicated that the placement of the disclosure in the Codification results in confusion about whether this disclosure applies only to performance obligations with corresponding contract balances or to all performance obligations.</td>
</tr>
<tr>
<td>The amendments in this Update clarify 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 corresponding contract balances.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issue 8: Contract Modifications Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 7 in Topic 606 illustrates the application of the guidance on contract modifications. Some stakeholders perceived minor inconsistencies with the contract modifications guidance in Topic 606.</td>
</tr>
<tr>
<td>The amendments in this Update better align Example 7 with the principles in Topic 606.</td>
</tr>
</tbody>
</table>

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11 At its October 19, 2016, meeting, the FASB redeliberated its original technical correction on disclosures of remaining performance obligations, which was discussed at the August 31, 2016, meeting but for which no tentative decision was reached. At the October 19 meeting, the staff presented five alternatives on the issue, which were compiled after additional outreach was performed at the request of the Board. After extensive deliberation, the Board ultimately decided to move forward with the amendments as originally proposed, but noted the importance of monitoring adoption of the disclosure requirements to determine what information preparers are disclosing and what information investors are using to identify whether additional amendments are necessary once implementation reviews are completed.
### Area for Correction or Improvement

#### Issue 9: Contract Asset Versus Receivable
Example 38, Case B in Topic 606 illustrates the application of the presentation guidance on contract assets and receivables. Some stakeholders expressed concern that the example indicates that an entity cannot record a receivable before its due date. The amendments in this Update provide a better link between the analysis in Example 38, Case B and the receivables presentation guidance in Topic 606.

#### Issue 10: Refund Liability
Example 40 in Topic 606 illustrates the recognition of a receivable and a refund liability. Some stakeholders expressed concern that the example indicates that a refund liability should be characterized as a contract liability. The amendment in this Update removes the reference to the term contract liability from the journal entry in Example 40.

#### Issue 11: Advertising Costs
Update 2014-09 supersedes much of the guidance in Subtopic 340-20, Other Assets and Deferred Costs — Capitalized Advertising Costs, because it would have conflicted with new cost capitalization guidance in Subtopic 340-40. Therefore, an entity that previously capitalized advertising costs in accordance with the guidance in Subtopic 340-20 would apply the capitalization guidance in Subtopic 340-40 upon the adoption of Update 2014-09. Guidance on when to recognize a liability had been included within Subtopic 340-20 and was inadvertently superseded by Update 2014-09. The amendments in this Update reinstate the guidance on the accrual of advertising costs and also move the guidance to Topic 720, Other Expenses.

#### Issue 12: Fixed-Odds Wagering Contracts in the Casino Industry
Subtopic 924-605, Entertainment — Casinos — Revenue Recognition, historically included explicit guidance that identifies fixed-odds wagering as gaming revenue. That industry-specific guidance was superseded by Update 2014-09, along with nearly all existing industry-specific revenue guidance in GAAP. Therefore, some stakeholders questioned whether fixed-odds wagering contracts are within the scope of Topic 606 or, rather, whether they should be accounted for as derivatives within the scope of Topic 815. The amendments in this Update (a) create a new Subtopic 924-815, Entertainment — Casinos — Derivatives and Hedging, which includes a scope exception from derivatives guidance for fixed-odds wagering contracts and (b) includes a scope exception within Topic 815 for fixed-odds wagering contracts issued by casino entities.

#### Issue 13: Cost Capitalization for Advisors to Private Funds and Public Funds
A consequential amendment included in Update 2014-09 moved cost guidance from Subtopic 946-605, Financial Services — Investment Companies — Revenue Recognition, to Subtopic 946-720, Financial Services — Investment Companies — Other Expenses. This amendment was intended to move the guidance only and was not intended to change practice. However, the consequential amendment in Update 2014-09 could have resulted in inconsistent accounting for offering costs among advisors to public funds and private funds. The amendments in this Update align the cost-capitalization guidance for advisors to both public funds and private funds in Topic 946.
ASU 2016-20 is based on two proposed ASUs. All except one of the amendments proposed in those exposure drafts are included in the final ASU. For the exception, which addresses preproduction costs related to long-term supply arrangements, the FASB subsequently decided to discontinue reconsideration of that topic because the Board concluded that additional guidance was not necessary.

20.3.3.7 ASU 2017-13 on Amendments to SEC Paragraphs and Rescission of Prior SEC Staff Announcements and Observer Comments

On September 29, 2017, the FASB issued ASU 2017-13, which amends the transition guidance in ASC 606-10-65 to include the SEC staff announcement at the July 20, 2017, EITF meeting regarding the ability for certain PBEs to use the non-PBE effective date when adopting the new revenue standard. For more information about this staff announcement, see Section 20.2.2.5.

In addition, ASU 2017-13 rescinds the SEC staff guidance in ASC 605-20-S99-1 (formerly EITF Issue D-96) on accounting for management fees based on a formula upon adoption of the new revenue standard.

20.3.3.8 ASU 2017-14 on Amendments to SEC Paragraphs Pursuant to SAB 116 and SEC Release No. 33-10403

On November 22, 2017, the FASB issued ASU 2017-14, which codifies certain SEC guidance on revenue and rescinds other such guidance that is superseded. Specifically, the ASU codifies in ASC 606-10-S25-1 the text of the SEC’s 2017 release on recognizing revenue from vaccines placed in a federal government stockpile and rescinds the legacy SEC guidance in ASC 605-15-S99-1 on this topic. For more information about the SEC’s 2017 release, see Section 20.2.1.2.

In addition, ASU 2017-14 rescinds certain SEC staff guidance in light of SAB 116. As discussed in Section 20.2.1.1, SAB 116 provides that SAB Topics 8 and 13 will no longer be applicable when an SEC registrant adopts ASC 606. Accordingly, ASU 2017-14 rescinds the following SEC staff guidance upon adoption of ASU 2014-09:

- ASC 605-10-S99-1, in which the text of SAB Topic 13 was codified to reflect the SEC staff's views on general recognition guidance.
- ASC 605-15-S99-2, in which the text of SAB Topic 8.A was codified to reflect the SEC staff's views on retailers' recognition of revenue from (1) sales of leased or licensed departments and (2) fees on commissions in a service arrangement.
- ASC 605-15-S99-3, in which the text of SAB Topic 8.B was codified to reflect the SEC staff's views on disclosures related to finance charges imposed by department stores and other retailers on credit sales.

Further, ASU 2017-14 amends the guidance in ASC 220-10-S99-7 to reflect SAB 116’s amendments to SAB Topic 11.A, as discussed in Section 20.2.1.1. Specifically, ASU 2017-14 amends the guidance in ASC 220-10-S99-7 to clarify that operating-differential subsidies presented under a revenue caption must be presented separately from revenue from contracts with customers accounted for under ASC 606.
20.3.3.9 ASU 2018-08 on Accounting for Contributions Received and Made
On June 21, 2018, the FASB issued ASU 2018-08, which clarifies the scope and accounting guidance for contributions received and made. Specifically, the ASU indicates that its amendments are intended, in part, to help entities evaluate “whether transactions should be accounted for as contributions (nonreciprocal transactions) within the scope of [ASC 958] or as exchange (reciprocal) transactions subject to other guidance," such as ASC 606. The ASU explains that while the issues it aims to address have been long-standing, “the amendments in [ASU 2014-09] place an increased focus on the issues because those amendments add new disclosure requirements and eliminate certain limited exchange transaction guidance that was previously contained in [ASC] 958-605.”

20.3.3.10 ASU 2018-18 on Clarifying the Interaction Between ASC 808 and ASC 606
On November 5, 2018, the FASB issued ASU 2018-18, which contains targeted improvements to the guidance on collaborative arrangements in ASC 808. See Section 3.2.9 for further discussion of collaborative arrangements and the ASU’s amendment to ASC 606-10-15-3.

20.3.3.11 ASU 2019-08 on Share-Based Consideration Payable to a Customer
On November 11, 2019, the FASB issued ASU 2019-08, which clarifies the accounting for share-based payments issued as consideration payable to a customer in accordance with ASC 606. Under the ASU, entities apply the guidance in ASC 718 to measure and classify share-based payments issued to a customer that are not in exchange for a distinct good or service (i.e., share-based sales incentives). See Section 6.6 for further details.

20.3.3.12 ASU 2020-05 on Deferral of the Effective Date for Certain Entities
On June 3, 2020, the FASB issued ASU 2020-05, which amends the effective dates of the Board’s standards on revenue (ASC 606) and leasing (ASC 842) to give immediate relief to certain entities as a result of the widespread adverse economic effects and business disruptions caused by the coronavirus disease 2019 ("COVID-19") pandemic. Specifically, the Board deferred the effective dates of (1) ASC 606 for private companies and private not-for-profit entities and (2) ASC 842 for private companies, private not-for-profit entities, and public not-for-profit entities. Nonpublic entities (i.e., entities that are not PBEs) may elect to adopt ASC 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. However, the deferrals apply only if those entities have not yet issued their financial statements (or made their financial statements available for issuance) as of June 3, 2020. See Section 16.1 for further details.
20.4 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.

The AICPA publication *Revenue Recognition Task Force — Status of Implementation Issues* summarizes the implementation issues that were discussed by each industry task force. Unless otherwise indicated in that publication, each implementation issue summarized therein has been finalized and included in the AICPA Audit and Accounting Guide *Revenue Recognition*. Refer to the AICPA's Web site for status updates and further information about the industry task forces.
Chapter 21 — Implementation Activities

21.1 Overview

Although public business entities (PBEs) have already adopted the new revenue standard, certain entities that are not PBEs (or certain emerging growth companies (EGCs) that have elected to adopt ASC 606 by using the non-PBE effective date) may still be transitioning to the standard. For example, certain entities that are not PBEs and have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, may elect to adopt the new revenue standard for annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020. While the impact of adoption will vary by industry, it is important for all entities to have an implementation plan in place to ensure that they fully consider all components affected by adoption of the standard before moving forward. It is 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 should 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 existing IT system(s).

The process of gathering and analyzing information plays 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.
While this chapter discusses implementation activities that apply to PBEs, most of those activities also apply to entities that are not PBEs. The objective of this chapter is to (1) help entities in their planning and assessment process and (2) provide entities that are 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 that objective, this chapter is laid out as follows:

- **Getting Started (Section 21.2 below)** — 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 21.3)** — 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 21.4)** — 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 21.5)** — 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 21.6)** — This section discusses the multiple practical expedients provided to ease the burden of implementing the new revenue standard.

- **Other Considerations (Section 21.7)** — The remainder of Chapter 21 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.

### 21.2 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, and 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 D provides an illustrative roadmap to help entities develop a plan for implementation. Refer to Section 21.3 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 legacy revenue guidance. Historically, entities may not have 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 regarding 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** — Many of 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** — Various publications in this series discuss the impact of the adoption of ASC 606 on selected industries, including aerospace and defense, financial services, life sciences, and telecommunications.

- **Deloitte’s TRG Snapshot publications** — These newsletters were issued after each TRG meeting to summarize the topics discussed and views expressed by the TRG.

- **Deloitte’s Accounting Spotlight publications** — Many of these newsletters address hot topics related to the new revenue standard, including identification of performance obligations, how to account for contract modifications, and other challenging issues.

**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 include only a small group of accounting personnel on the transition/implementation team.

- Do not forget to download the Background Information and 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 or functional 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 spreadsheet software as a viable solution for all changes associated with adoption.

### 21.3 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 D) is our illustrative implementation roadmap, which may help entities as they prepare their own roadmaps. The purpose of our illustrative implementation 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.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Understanding, Education, and Planning</th>
<th>Assessment</th>
<th>Implementation</th>
<th>Sustainability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk assessment</td>
<td>Perform risk assessment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical accounting</td>
<td>Understand the standard</td>
<td>Identify contracts</td>
<td>Develop accounting policy documentation</td>
<td>Audit review of compliance methodology</td>
</tr>
<tr>
<td></td>
<td>Perform contract evaluations</td>
<td>Finalize transition plan</td>
<td>Auditor review of contract/policy</td>
<td></td>
</tr>
<tr>
<td>Data and system development</td>
<td>Data retention strategy</td>
<td>Systems architecture options</td>
<td>Execute data retention strategy</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounting rules and business requirements</td>
<td>Develop accounting rules</td>
<td>Test accounting rules</td>
<td></td>
</tr>
<tr>
<td>Process/close, consolidate, and report</td>
<td>Consider existing disclosures</td>
<td>Consider COSO principles</td>
<td>Design infrequent event controls</td>
<td>Monthly close processes/staffing</td>
</tr>
<tr>
<td>Tax compliance and accounting</td>
<td>Evaluate tax reporting requirements</td>
<td>Tax reporting implementation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Readiness and training</td>
<td>Hold initial training sessions</td>
<td></td>
<td>Training rollout</td>
<td></td>
</tr>
<tr>
<td>Program management</td>
<td>Develop program management plan</td>
<td></td>
<td></td>
<td>Periodic steering committee updates</td>
</tr>
</tbody>
</table>
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 21.3.1 through 21.3.4 below discuss the four phases of adopting the new revenue standard, as shown in our illustrative implementation roadmap above.

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 21.3.1 through 21.3.4 highlight some of the activities associated with each phase. For a complete listing of the activities associated with each phase, refer to Appendix D.

### 21.3.1 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 21.3.1.1 through 21.3.1.4 below discuss a number of the significant activities performed during this initial phase.

#### 21.3.1.1 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 and revenue streams 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 legacy 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 13 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 revenue 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 white papers, narratives, and process flows to understand existing 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 legacy 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.

### 21.3.1.2 Process/Close, Consolidate, and Report

As part of the first phase of the adoption process, an entity should consider its existing 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 existing 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 20.2.2.1 and 21.7.

\(^1\) 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 an SEC registrant, such considerations include a disclosure of any material changes in the registrant's internal control over financial reporting (ICFR) in a Form 10-Q or Form 10-K in accordance with SEC Regulation S-K, Item 308(c). For additional considerations related to internal controls, see Section 21.5.

### 21.3.1.3 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 to incorporate interpretive guidance and updates based on TRG meetings, AICPA working group implementation efforts, FASB staff implementation Q&As, and other 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.

### 21.3.2 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 21.3.1 through 21.3.1.3). In addition, entities will perform new activities, as described in the sections below.

#### 21.3.2.1 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) discuss these policies with their auditors. For additional information, see Section 21.4.3.

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 21.4.1. 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.

21.3.2.2 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 for financial reporting purposes.

21.3.2.3 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 19.

21.3.3 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.

21.3.3.1 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 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.” As further discussed in Chapter 15, ASC 606 disclosure requirements, which are more comprehensive than legacy 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.

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7 Specifically, ASC 606-10-50-1 through 50-23.
8 Quoted from ASC 606-10-50-1.
• A disaggregation of revenue to “depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.” 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)” 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.

### 21.3.3.2 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 legacy 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 enterprise resource planning (ERP) vendors themselves may be necessary to mitigate this potential risk. An entity may also need to consider any potential differences between U.S. GAAP and IFRS Standards that system solutions may need to capture. Refer to Appendix A for a listing of differences between U.S. GAAP and IFRS Standards that may warrant consideration when an entity is designing system solutions.

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9 Quoted from ASC 606-10-50-5.
10 Quoted from ASC 606-10-50-13.
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 D outlines some key steps to help inform entities about system modifications that may be required when the new revenue standard is adopted.

### 21.3.3.3 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.

### 21.3.4 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 an entity adopts the new revenue standard, it should perform a postimplementation review to ensure that (1) it is aware of any changes and developments related to interpretative guidance, (2) it accounts for the impact of adopting other accounting standards (e.g., ASC 842 on leases), (3) any system modifications or upgrades are functioning as intended, (4) any changed or newly implemented internal controls are operating effectively, (5) its personnel are following the new accounting policies, and (6) its disclosures are comparable to those prepared by other entities in the same industry or industries. Depending on the outcome of the postimplementation review, some entities may need to continually dedicate resources to ensure compliance with the new revenue standard. To ensure success during the sustainability phase, we would encourage entities to continuously monitor external activities (e.g., SEC comment letter trends and issues discussed by the AICPA industry task forces and public accounting firms). Consequently, this phase of the process should not be dismissed.

### 21.4 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 21.3 through 21.3.4.

#### 21.4.1 Determining a Transition Approach

Chapter 16 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. Although the majority of SEC registrants have already adopted ASC 606, certain EGCs that have elected to adopt the new revenue standard by using the non-PBE effective date may still need to consider the applicable SAB 74 disclosures in upcoming financial statements.
The table below lists key observations and challenges related to each transition method.

<table>
<thead>
<tr>
<th></th>
<th>Full Retrospective</th>
<th>Modified Retrospective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dual reporting requirements</td>
<td>Prior two comparative years (potentially three) required to be restated.</td>
<td>Dual recordkeeping required in the year of adoption.</td>
</tr>
<tr>
<td>Comparability</td>
<td>Full comparability as prior periods are restated.</td>
<td>No comparability between current year and prior periods on primary financial statements.</td>
</tr>
<tr>
<td></td>
<td>Cumulative catch-up adjustment recorded at the beginning of the earliest period presented (e.g., January 1, 2016, for a public company with a calendar year-end).</td>
<td>Year of adoption comparability provided in footnote disclosures.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cumulative catch-up adjustment recorded on the date of adoption (e.g., January 1, 2018, for a public company with a calendar year-end).</td>
</tr>
<tr>
<td>System considerations</td>
<td>The full retrospective method requires information to be prepared and validated before the date of adoption. Procedural “trial runs” will provide opportunity to fix potential unforeseen or unplanned challenges.</td>
<td>More time to develop a one-time transition plan with more runway to fix data and system challenges ahead of “go-live” on the date of adoption.</td>
</tr>
</tbody>
</table>

To expand on the table above, Sections 21.4.1.1 (below) and 21.4.1.2 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.

### 21.4.1.1 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 legacy 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 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).
21.4.1.2 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. 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 20.2.2.2 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.

21.4.2 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.

21.4.3 Accounting Policies

In conjunction with assessing system changes and other updates required upon adoption, refreshing accounting policies used under legacy 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 340-40 on contract costs. It is also important for an entity to continually discuss critical accounting decisions with its auditors.

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11 See ASC 606-10-65-1(1).
12 See ASC 606-10-10-4.
21.4.3.1 Significant Judgments

It is important to understand that the new revenue standard will most likely require entities to exercise greater judgment than that required under legacy revenue guidance. Therefore, updating existing accounting policies to comply with the guidance in ASC 606 may be a challenge. Entities will need to ensure that their updated accounting policies are robust enough to capture all of the significant judgments that are required under ASC 606, including, but not limited to, the following:

- The identification of distinct performance obligations (specifically, the determination of whether promised goods or services are distinct within the context of the contract).
- The determination of whether a performance obligation is satisfied over time or at a point in time. This determination will be especially important for enabling entities that manufacture products with no alternative use to determine whether there is an enforceable right to payment in their contracts.
- The estimation of variable consideration and application of the constraint.
- The determination of whether it is probable that the consideration to which the entity expects to be entitled will be collected.
- The estimation of stand-alone selling prices, which may be specifically relevant for companies that were unable to establish vendor-specific objective evidence of fair value under legacy guidance.

As discussed in Section 15.3, entities are also required to disclose information about significant judgments and estimates they made in applying the new revenue standard. Accordingly, entities may find it useful and efficient to update their accounting policies and draft disclosures related to significant judgments and estimates concurrently.

21.4.4 System Modifications

As discussed in Section 21.3.3.2, 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 existing 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 existing 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.

21.5 Internal Control Over Financial Reporting

To ensure reliable financial reporting, an entity must maintain a strong system of internal control. SEC filing data show that revenue recognition is one of the most common accounting issues that trigger a material weakness.\(^\text{13}\) This evidence underscores the importance of focusing on the internal control impacts of adopting the new revenue standard.

\(^\text{13}\) Based on data from Audit Analytics for fiscal years ending 2010 through 2018 as reported in auditor ICFR attestation reports.
Further, the SEC staff has emphasized on multiple occasions the need for preparers to focus on ICFR in connection with implementation activities. In a speech at the 13th Annual Life Sciences Accounting & Reporting Congress on March 21, 2017, SEC Chief Accountant Wesley Bricker reiterated that emphasis, reminding preparers of the importance of updating and maintaining internal controls as they implement the new revenue standard.

Mr. Bricker indicated that the following “lessons have been learned over time” and that preparers should consider them with the aim of “providing high-quality financial information that investors can rely on”:

- **Need for adequate resources** — Mr. Bricker noted that “[a]ll companies must have appropriate resources to evaluate revenue arrangements and properly apply the principles of the new standard” and that “having resources with sufficient training and competence is fundamental to the effectiveness of a company’s overall control environment.” An entity’s internal audit department could play a pivotal role in the evaluation of necessary modifications to the entity’s internal controls, including, but not limited to, modifications related to (1) identifying and assessing risks, (2) identifying and designing (or redesigning) relevant controls, and (3) monitoring the effectiveness of control activities.

- **Tone at the top** — The control environment component of the 2013 COSO Framework includes a separate principle related to commitment to integrity and ethical values, or setting the appropriate “tone at the top.” Mr. Bricker remarked that “[a]ppropriate tone at the top is the foundation for the consistent application of the sound judgments required by the new standard. Management should consider whether the existing controls support the formation and enforcement of sound judgments or whether changes are necessary.”

- **Consider changes to established business practices** — Potential areas of change could include processes for preparing required disclosures (including gathering, analyzing, and sharing necessary information with relevant parties) and information systems that support the financial reporting process.

- **Comprehensive and timely assessment of risks** — Mr. Bricker stated that the “effectiveness of any changes to internal controls are predicated on a comprehensive and timely assessment of risks that may arise as a result of applying the standard. Such risks may exist at various levels and in different areas of a company and their appropriate identification and assessment may require involvement of management and employees from both the accounting and financial reporting function and other functional areas of a company.”

Entities should identify internal controls to address risks of material misstatement specific to the following:

- Preadoption disclosures (see Section 21.5.1).
- Adoption of the new revenue standard (see Section 21.5.2).
- New recognition principles and the five-step model (see Section 21.5.3).

In addition, to the extent that an entity implements a material change in its ICFR, the entity is required to provide disclosures related to that material change. Refer to Section 21.5.4 for additional information about these disclosures.
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

#### Control environment
- Evaluate and update lines of reporting and responsibilities.
- Assess and monitor competencies required under the new revenue standard.

#### Risk assessment
Reevaluate risk assessment throughout the adoption process to identify new and modify existing risks, including those related to fraud and the potential for fraud.

#### Control activities
- In response to new or revised risks, design new controls or modify existing ones.
- Revise and update accounting policies and related documentation.

#### Information and communication
- Update reports or data requirements, and modify controls to ensure data quality.
- Communicate changes internally, and provide updates as appropriate.
- Provide external disclosures as appropriate (e.g., changes in protocols and impact of adoption).

#### Monitoring activities
- Perform timely evaluations of control activities.
- Consider whether separate evaluation is needed (e.g., by internal audit).

### 21.5.1 Preadoption Disclosure Controls

The SEC has emphasized the importance of transition-period disclosures (or preadoption disclosures) in accordance with SAB 74 (codified in SAB Topic 11.M) (see Section 21.7.1 for additional information about these disclosures). As noted in Section 21.4.1, although the majority of SEC registrants have already adopted ASC 606, certain EGCs that have elected to adopt the new revenue standard by using the non-PBE effective date may still need to consider the applicable SAB 74 disclosures in upcoming financial statements. It is important that the entity has internal controls to address the risks that these preadoption disclosures are inaccurate or incomplete. Management should first identify the relevant internal controls over the disclosures, as well as the information and analysis used to develop the disclosures. When applicable, management would then test the design and operating effectiveness of the relevant controls since such controls should be included within the scope of management’s report on ICFR in the year before the adoption of the new revenue standard.
When assessing whether appropriate internal controls exist with respect to the preadoption disclosures, management may consider whether procedures are in place regarding:

- **Competence** — The preadoption disclosures are prepared by competent individuals with knowledge of the new revenue standard and potential impacts on the company.
- **Compliance** — The disclosures meet the SEC’s requirements and guidelines.
- **Data quality** — The quantitative disclosures (if known and estimated) are calculated on the basis of reliable inputs that are subject to appropriate internal control.
- **Review** — The disclosures are reviewed by appropriate levels of management.
- **Monitoring** — The company’s monitoring function (e.g., internal audit, disclosure committee, or audit committee) appropriately evaluates the internal controls in accordance with company protocols. In addition, the audit committee is involved in the oversight of the disclosures’ preparation.

**21.5.2 Internal Controls Over the Adoption**

There are often unique circumstances and considerations associated with the adoption of a new accounting standard that can pose a higher risk of material misstatement to the financial statements. Thus, companies should consider the circumstances that may only be present during the adoption period and evaluate whether there are any unique risks that require “one-time” internal controls that may operate exclusively during the adoption period. Management should also consider the internal controls, documentation, and evidence it needs to support:

- Entity-level controls such as the control environment and general “tone at the top.”
- Identification and evaluation of a complete population of revenue streams and different contract types within those revenue streams.
- Accounting conclusions reached (such as by preparing accounting white papers or internal memos memorializing management’s considerations and conclusions), including the impact to other account balances such as costs of sales or services, contract assets and liabilities, and income tax accounts.
- Information used to support accounting conclusions, new estimates, adjustments to the financial statements, and disclosure requirements.
- Identification and implementation of changes to IT systems, including the logic of reports.
- The transition approach selected.
- The accounting logic used and journal entries (including the transition adjustments) that record the adoption’s impact.
- Any practical expedients applied and related disclosures.
- Changes to the monthly, quarterly, or annual close process and related reporting requirements (e.g., internal reporting, disclosure controls and procedures).

**21.5.3 New Recognition Principles and Five-Step Model**

As a result of the new five-step model for recognizing revenue, it is possible that new financial reporting risks will emerge, including new or modified fraud risks, and that new processes and internal controls will be required. Companies will therefore need to consider these new risks and how to change or modify internal controls to address the new risks.
For example, in applying the five-step model, management will need to make significant judgments and estimates (e.g., the determination of variable consideration and whether to constrain variable consideration). It is critical for management to (1) evaluate the risks of material misstatement associated with these judgments and estimates, (2) design and implement controls to address those risks, and (3) maintain documentation that supports the assumptions and judgments that underpin its estimates. The table below lists examples of risks and controls that an entity may consider when applying the five-step model.

<table>
<thead>
<tr>
<th>Core Considerations</th>
<th>Examples of Risks</th>
<th>Examples of Control Considerations14</th>
</tr>
</thead>
</table>
| 1. Identify the contract with the customer | • Revenue is/is not recognized when a contract (as defined by the new revenue standard) does not exist/does exist.  
• Side agreements exist that are not known to accounting personnel. | Internal controls related to:  
• Identifying contracts that meet the criteria defined in the new revenue standard.  
• Reassessing arrangements that do not initially meet the criteria of a contract in accordance with the new standard given that significant changes may occur in the underlying facts and circumstances.  
• Assessing management’s commitment and ability to perform under the contract.  
• Ensuring payment terms are properly considered.  
• Assessing the collectibility criterion.  
• Evaluating whether combined contracts meet the various criteria specified in the new standard.  
• Evaluating contract modifications. |
| 2. Identify the performance obligations | Performance obligations are not properly identified. | Internal controls related to:  
• Identifying implied promises.  
• Evaluating whether customer options are material rights.  
• Evaluating whether a warranty is a performance obligation.  
• Evaluating whether the good(s) or service(s) is/are capable of being distinct within the context of the contract or if two or more goods or services should be combined.  
• Evaluating whether a series of goods or services should be treated as a single performance obligation. |
| 3. Determine the transaction price | Management’s estimates are inaccurate as a result of an inappropriate method or inappropriate significant assumptions. | Internal controls related to:  
• Estimating the amount to which the entity expects to be entitled including variable consideration and constraining variable consideration.  
• Reevaluating the accuracy of judgments and assumptions used in estimates for variable consideration.  
• Determining the fair value of noncash consideration.  
• Determining significant financing components.  
• Determining noncash consideration.  
• Determining consideration payable to a customer. |

14 One or more controls may address one or more risks. The number of controls a company may have will vary depending on how the controls are designed to address the company’s risks.
### Core Considerations | Examples of Risks | Examples of Control Considerations
---|---|---
4. Allocate the transaction price | Management’s estimates are inaccurate as a result of an inappropriate method or inappropriate significant assumptions. | Internal controls related to: • Selecting an approach for determining the stand-alone selling price that maximizes the use of observable data. • Estimating the stand-alone selling price. • Determining the appropriate transaction price allocation including variable consideration and discounts. • Reevaluating the accuracy of judgments and assumptions used in estimates for the determination of the stand-alone selling price.

5. Recognize revenue when (or as) performance obligations are satisfied | Revenue is recognized before the performance obligation is satisfied. | Internal controls related to: • Determining whether performance obligations are satisfied at a point in time or over time. • Identifying when control transfers to the customer for a performance obligation satisfied at a point in time. • Measuring progress toward complete satisfaction of a performance obligation that is satisfied over time (i.e., the input and output methods).

**Licensing** | Licensing revenue is improperly recognized. | Internal controls related to: • Determining whether the license is distinct. • Identifying the nature of the license (functional vs. symbolic). • Determining whether obligations to provide updates to, or maintenance of, licensed intellectual property are distinct. • Accounting for sales- or usage-based royalties.

**Contract costs** | Costs incurred with obtaining or fulfilling a contract are inappropriately capitalized. | Internal controls related to: • Evaluating whether the cost of obtaining or fulfilling a contract may be capitalized on the basis of the criteria of the new standard. • Amortizing capitalized contract costs.

**Presentation and disclosure** | • Contract assets and liabilities are not presented appropriately. • Footnote disclosures are not accurate, complete, or understandable. | Internal controls related to: • Evaluating whether to present contract assets and liabilities as current or noncurrent. • Determining the level of aggregation or disaggregation of the disclosures. • Reviewing the accuracy and completeness of contract disclosures. • Reviewing the disclosures of significant judgments and estimates.
Companies will need to gather and track new information to comply with the five-step model and related disclosure requirements. Management should consider whether appropriate controls are in place to support (1) the necessary IT changes (including change management controls and, once the IT changes have been implemented, the testing of their design and operating effectiveness) and (2) the accuracy of the information used by the entity to recognize revenue and provide the related disclosures. The table below illustrates some potential challenges and examples of practices.

<table>
<thead>
<tr>
<th>Potential Challenge</th>
<th>Example of Internal Control Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information requirements have not been updated to support the reporting (e.g., interim and annual requirements, including disclosures) required under the new revenue standard.</td>
<td>Management establishes data governance, policies, and standards for identifying and resolving data gaps and implements processes to verify the quality of information needed for implementation of the new revenue standard.</td>
</tr>
<tr>
<td>Control expectations have not been considered for new information required under the new revenue standard.</td>
<td>The revenue recognition implementation team meets periodically with the ICFR/SOX team (and control owners as appropriate) to share relevant information about the adoption of the new standard so that the ICFR/SOX team can prepare and plan accordingly.</td>
</tr>
<tr>
<td>Internal controls over source data, report logic, or parameters have not been reconsidered.</td>
<td>Management takes steps to update and review the appropriate flowcharts, data flow diagrams, process narratives, procedure manuals, and control procedures to reflect the new processes as a result of the new standard and to support management's ICFR assessment.</td>
</tr>
</tbody>
</table>

### 21.5.4 Disclosure of Material Changes in ICFR

SEC registrants are required to disclose any material changes (including improvements) in their ICFR in each quarterly and annual report in accordance with Regulation S-K, Item 308(c). SEC guidance explains that materiality would be determined on the basis of the impact on ICFR and the materiality standard articulated in TSC Industries Inc. v. Northway Inc. (i.e., that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”).

As discussed in Sections 21.5 through 21.5.3, the adoption of the new revenue standard will probably require management to implement new controls or modify existing ones to address new or modified risks of material misstatement. Such changes in internal control, if material as a result of the adoption of a new accounting standard, will trigger disclosure requirements. In addition, management should consider whether there are appropriate controls with respect to identifying and disclosing material changes in ICFR.

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16 SEC Final Rule No. 33-8238, Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, states that management “must evaluate, with the participation of the issuer’s principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.”
For example, management may consider whether there are controls related to the following:

- **Compliance** — Processes are in place to identify and evaluate material changes in internal control. Further, protocols exist for developing appropriate disclosures and reporting such information to appropriate levels of management (e.g., those signing the quarterly and annual certifications required under SEC Regulation S-K, Item 601(b)(31)).

- **Review** — The disclosures are reviewed by appropriate levels of management (including, as warranted, those signing the quarterly and annual certifications).

- **Monitoring** — The company’s monitoring function (e.g., internal audit, disclosure committee, or audit committee) appropriately considers the state of the entity’s ICFR to identify changes and monitors controls in accordance with company protocols. In addition, the audit committee is involved in the oversight of the disclosures’ preparation.

In developing the required disclosures, companies should clearly state whether a material change has occurred and, if so, describe the nature of the change. The SEC staff has commented when a registrant has not explicitly asserted whether there has been a change in ICFR in the most recent fiscal quarter that could have a material effect on its ICFR. The staff has further stressed that registrants should avoid “boilerplate” disclosure in which they state that there have been no material changes affecting ICFR in a period, particularly when there have been identifiable events such as changes in accounting policies. For additional information about the disclosure of material changes in ICFR and examples of disclosures, see Deloitte’s May 9, 2017, *Heads Up*.

### 21.6 Practical Expedients

In addition to evaluating the important decisions outlined in Section 21.4, 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. An entity should apply the use of any practical expedients consistently to contracts with similar characteristics and in similar circumstances.

<table>
<thead>
<tr>
<th>Practical Expedient</th>
<th>Availability Under U.S. GAAP, IFRS Standards, or Both</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ongoing</strong></td>
<td><strong>ASC 606-10-32-18</strong></td>
</tr>
<tr>
<td>Significant financing component</td>
<td>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.</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>An entity may elect to exclude from its transaction price any amounts collected from customers for all sales (and other similar) taxes.</td>
</tr>
<tr>
<td>Costs of obtaining a contract</td>
<td>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.”</td>
</tr>
</tbody>
</table>
### Policy Elections Affecting the Measurement and Recognition of Revenue

<table>
<thead>
<tr>
<th>Application</th>
<th>Codification Reference</th>
<th>Practical Expedient</th>
<th>Availability Under U.S. GAAP, IFRS Standards, or Both</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ongoing</td>
<td>ASC 606-10-25-18B</td>
<td><strong>Shipping and handling</strong> — 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.</td>
<td>U.S. GAAP only</td>
</tr>
<tr>
<td>Ongoing</td>
<td>ASC 606-10-10-4</td>
<td><strong>Portfolio approach</strong> — 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.”</td>
<td>U.S. GAAP and IFRS Standards</td>
</tr>
<tr>
<td>Ongoing</td>
<td>ASC 606-10-55-18</td>
<td><strong>Right to invoice</strong> — 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.”</td>
<td>U.S. GAAP and IFRS Standards</td>
</tr>
</tbody>
</table>

### Policy Elections Affecting Disclosures

<table>
<thead>
<tr>
<th>Application</th>
<th>Codification Reference</th>
<th>Disclosure:</th>
</tr>
</thead>
</table>
| Ongoing     | ASC 606-10-50-14 and 50-14A | • An entity need not 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 paragraph 606-10-55-18.  
• An entity need not disclose the information about its remaining performance obligations in ASC 606-10-50-13 for variable consideration if 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.  
• If these optional exemptions are elected, they should be applied entity-wide to all contracts. |

The first exemption is available under U.S. GAAP and IFRS Standards, and the second exemption is available under U.S. GAAP only.
(Table continued)

<table>
<thead>
<tr>
<th>Application</th>
<th>Codification Reference</th>
<th>Practical Expedient</th>
<th>Availability Under U.S. GAAP, IFRS Standards, or Both</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-time</td>
<td>ASC 606-10-65-1(f)</td>
<td>Transition:</td>
<td>U.S. GAAP and IFRS Standards</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 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:</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>1. An entity need not restate contracts that begin and are completed within the same annual reporting period.</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>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.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>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).</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>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:</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>i. Identifying the satisfied and unsatisfied performance obligations</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>ii. Determining the transaction price</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>iii. Allocating the transaction price to the satisfied and unsatisfied performance obligations.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Any practical expedient in ASC 606-10-65-1(f) that is elected should be applied entity-wide to all contracts.</td>
<td></td>
</tr>
</tbody>
</table>

For many of the practical expedients outlined above, the new revenue standard requires disclosure that an entity has elected such policy. See Chapter 15 for disclosure requirements.
21.7 Other Considerations

21.7.1 SAB Topic 11.M Disclosures

As discussed in Section 20.2.2.1, members of the SEC staff have emphasized on numerous occasions 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 21.4.1) but also disclosures that explain the impact that the new revenue standard is expected to have on an entity’s financial statements. As noted in Section 21.4.1, although the majority of SEC registrants have already adopted ASC 606, certain EGCs that have elected to adopt the new revenue standard by using the non-PBE effective date may still need to consider the applicable SAB 74 disclosures in upcoming 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 21.3.2.1) 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:

<table>
<thead>
<tr>
<th>Illustrative Disclosures — Adoption of New Accounting Standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 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].</td>
</tr>
<tr>
<td>• [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 legacy guidance.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
</tbody>
</table>

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 a speech at the 13th Annual Life Sciences Accounting & Reporting Congress on March 21, 2017, SEC Chief Accountant Wesley Bricker reminded registrants of the importance of providing the transition-period disclosures, especially the need for preparers to provide sufficient qualitative and quantitative disclosures as the standard's adoption date draws closer. In discussing SAB 74 disclosures, Mr. Bricker observed the following:

[S]ome companies indicate that the impact of the new revenue standard is not expected to be material. The changes in the new standard will impact all companies. Even if the extent of change for a particular company is slight, the related disclosures to describe revenue streams may not be. The scope of the new [revenue] standard addresses not only amounts and timing of revenue but also new, comprehensive disclosures about contracts with customers, including the significant judgments the registrant has made when applying the guidance.

Mr. Bricker noted the tendency of preparers to deem immaterial — from a recognition, measurement, and presentation perspective — the impact of adopting the new standard. However, such preparers may not yet have assessed the standard's new, comprehensive disclosure requirements. He stated that SAB 74 disclosures should “reflect consideration of the full scope of the new standard, which covers recognition, measurement, presentation, and disclosure for revenue transactions” (emphasis added).

Accordingly, registrants’ transition disclosures should demonstrate an understanding of the qualitative and quantitative impact of the new standard, including its enhanced disclosure requirements. 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 20.2.2.7.

21.7.2 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. If 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 IFRS Standards

Although the FASB’s new guidance on revenue from contracts with customers is nearly fully converged with that of the IASB, there are differences between U.S. GAAP and IFRS Standards on revenue-related topics. Some of those differences are reflected in the following table:

<table>
<thead>
<tr>
<th>Topic</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1 — the collectibility threshold</td>
<td>The guidance establishes a probable collectibility threshold, meaning likely to occur.(^1)</td>
<td>The guidance establishes a probable collectibility threshold, meaning more likely than not.(^2)</td>
</tr>
<tr>
<td>for contracts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reversal of impairment losses</td>
<td>An entity cannot reverse an impairment loss on capitalized costs to obtain or fulfill a contract.</td>
<td>An entity is required to reverse an impairment loss on capitalized costs to obtain or fulfill a contract if the impairment conditions no longer exist or have improved.</td>
</tr>
<tr>
<td>Interim disclosures</td>
<td>In addition to those required by ASC 270, an entity must provide interim disclosures about each of the following:</td>
<td>IFRS 15 amended IAS 34 to require an entity to provide interim disclosures about the disaggregation of revenue.</td>
</tr>
<tr>
<td></td>
<td>• The disaggregation of revenue.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Contract asset and contract liability balances and significant changes in those balances.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The transaction price allocated to the remaining performance obligations.</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) As defined in ASC 450.

\(^2\) As defined in IFRS 15 and IAS 37.
### Table continued

<table>
<thead>
<tr>
<th>Topic</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
</table>
| Effective date               | • **Public entities** — Effective for annual reporting periods beginning after December 15, 2017.  
  • **Nonpublic entities** — Allowed a one- or two-year delay.  
  • **Early adoption** — Allowed for annual reporting periods beginning on or after December 15, 2016. Nonpublic entities can adopt no earlier than public entities. | • Effective for annual reporting periods beginning on or after January 1, 2018.  
  • Early adoption is allowed. |

#### Requirements for nonpublic entities

The guidance applies to nonpublic entities, with some specific relief related to disclosure, transition, and effective date. Refer to Chapter 17 for additional information.

The guidance applies to all entities reporting under IFRS Standards, including nonpublic entities.

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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 U.S. GAAP and IFRS Standards that have arisen as a result of the amendments:

<table>
<thead>
<tr>
<th>Topic</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Licensing — determining the nature of an entity’s promise (see paragraphs BC51 through BC65 of ASU 2016-10)</td>
<td>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.</td>
<td>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 at which 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.</td>
</tr>
<tr>
<td>Licensing — renewals (see paragraphs BC48 through BC50 of ASU 2016-10)</td>
<td>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.</td>
<td>The “use and benefit” guidance does not explicitly refer to renewals. Consequently, revenue may be recognized earlier than it would be under U.S. GAAP.</td>
</tr>
</tbody>
</table>

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3 In June 2020, the FASB issued ASU 2020-05, which permits certain entities that are not public business entities and that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, an additional one-year deferral. See Chapter 16 for further discussion of effective date and transition.
(Table continued)

<table>
<thead>
<tr>
<th>Topic</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipping and handling activities (see paragraphs BC19 through BC25 of ASU 2016-10)</td>
<td>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.</td>
<td>IFRS 15 does not include a similar election.</td>
</tr>
<tr>
<td>Noncash consideration (see paragraphs BC36 through BC43 of ASU 2016-12)</td>
<td>Under the amendments in ASU 2016-12, noncash consideration is measured at contract inception.</td>
<td>IFRS 15 does not prescribe a measurement date for noncash consideration.</td>
</tr>
<tr>
<td>Presentation of sales (and other similar) taxes (see paragraphs BC29 through BC35 of ASU 2016-12)</td>
<td>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.</td>
<td>IFRS 15 does not include a similar election.</td>
</tr>
<tr>
<td>Transition — date of application of the contract modification practical expedient (see paragraphs BC44 through BC48 of ASU 2016-12)</td>
<td>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.</td>
<td>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.</td>
</tr>
</tbody>
</table>
| 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 IFRS Standards].”  
• 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. |
| Provisions for losses on construction-type and production-type contracts | ASU 2016-20 amends the legacy guidance in ASC 605-35-25-47 to clarify that provisions for losses on construction-type and production-type contracts may be determined at either the contract or performance obligation level. | In accordance with IAS 37, the onerous test should be performed at the contract level. |
### Disclosure of remaining performance obligations

ASU 2016-20 provides entities with an optional exemption from the requirement to disclose information about remaining performance obligations (ASC 606-10-50-13) for variable consideration if either (1) the variable consideration is a sales- or usage-based royalty promised in exchange for a license of IP or (2) 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.

IFRS 15 was not amended to provide similar disclosure relief.

### Share-based payments to customers

ASU 2019-08 clarifies the accounting for share-based payments to customers and requires the application of ASC 718 for measurement and classification purposes (e.g., share-based consideration payable to a customer is calculated by using its fair-value-based measure as of the grant date).

IFRS Standards do not include similar guidance.

Further, some of the boards’ respective amendments to the new revenue standard are generally expected to produce similar outcomes under U.S. GAAP and IFRS Standards despite differences between the FASB's wording and that of the IASB. The following table provides examples of differently articulated but similar guidance under U.S. GAAP and IFRS Standards, as amended:

<table>
<thead>
<tr>
<th>Topic</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collectibility — criterion explanation and examples (see paragraphs BC9 through BC20 of ASU 2016-12)</td>
<td>ASU 2016-12 provides an additional explanation of the collectibility threshold's objective, as well as implementation guidance and examples.</td>
<td>No additional guidance provided.</td>
</tr>
<tr>
<td>Collectibility — recognition criterion for contracts that fail step 1 (see paragraphs BC21 through BC28 of ASU 2016-12)</td>
<td>ASU 2016-12 adds a third criterion to allow revenue recognition when a contract fails step 1 (ASC 606-10-25-1).</td>
<td>Additional criterion not provided.</td>
</tr>
<tr>
<td>Topic</td>
<td>U.S. GAAP</td>
<td>IFRS Standards</td>
</tr>
<tr>
<td>-------</td>
<td>-----------</td>
<td>----------------</td>
</tr>
<tr>
<td>Immaterial goods or services (see paragraphs BC8 through BC18 of ASU 2016-10)</td>
<td>When identifying performance obligations, an entity is not required to assess immaterial items in the context of the contract as promised goods or services.</td>
<td>Overall materiality considerations should be used in the evaluation of items under IFRS Standards.</td>
</tr>
<tr>
<td>Licensing — when to consider the nature of an entity's promise in granting a license (see paragraphs BC66 through BC69 of ASU 2016-10)</td>
<td>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.</td>
<td>No guidance added to IFRS 15; however, the Basis for Conclusions on IFRS 15 explains that the licensing implementation guidance does not override the general model — specifically, the requirements for identifying performance obligations before applying the criteria to determine the nature of an entity's promise in granting a license.</td>
</tr>
<tr>
<td>Licensing — contractual restrictions (see paragraphs BC41 through BC47 of ASU 2016-10)</td>
<td>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).</td>
<td>No guidance added to IFRS 15; however, the Basis for Conclusions on IFRS 15 explains that the license implementation guidance does not override the general model — specifically, the requirements for identifying performance obligations before applying the criteria to determine the nature of an entity's promise in granting a license.</td>
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<td>Licensing — hosting arrangements (see paragraph BC37 of ASU 2016-10)</td>
<td>ASU 2016-10 contains explicit guidance to indicate that the license implementation guidance is not applicable to software subject to a hosting arrangement that does not contain a license in accordance with the guidance in ASC 985-20-15-5.</td>
<td>No guidance added to IFRS 15; however, the Basis for Conclusions on IFRS 15 explains that the license implementation guidance does not override the general model — specifically, the requirements for identifying performance obligations before applying the criteria to determine the nature of an entity's promise in granting a license.</td>
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<td>Contract costs — impairment testing</td>
<td>ASU 2016-20 clarifies that when an entity tests capitalized contract costs for impairment, it should (1) consider expected contract renewals and extensions and (2) include any amount of consideration not yet recognized as revenue (i.e., consideration already received and amounts expected to be received in the future).</td>
<td>No additional guidance provided on specific factors that an entity should consider when testing capitalized contract costs for impairment.</td>
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</table>
In addition, there are certain differences between legacy U.S. GAAP and IFRS Standards. While certain of the boards’ respective amendments — especially the FASB’s amendments in ASU 2016-20 — are not expected to create a new difference between U.S. GAAP and IFRS Standards, these amendments are also not expected to result in convergence between U.S. GAAP and IFRS Standards. The following table provides examples of where existing differences have been carried forward under the new revenue standard:

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<td>Disclosure of prior-period performance obligations</td>
<td>ASU 2016-20 provides additional guidance to clarify that the disclosure of revenue from performance obligations satisfied (or partially satisfied) in prior periods applies to all performance obligations (i.e., the disclosure is not isolated to performance obligations with corresponding contract liability balances).</td>
<td>No additional guidance provided.</td>
</tr>
<tr>
<td>Contract modifications example</td>
<td>ASU 2016-20 amends Example 7 in ASC 606-10-55-125 through 55-128 to better align the wording with the contract modification guidance in ASC 606-10-25-10 through 25-13.</td>
<td>No amendments made to Example 7 in IFRS 15.</td>
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<tr>
<td>Contract asset versus receivable</td>
<td>ASU 2016-20 amends Example 38, Case B, in ASC 606-10-55-285 and 55-286 to provide a better link between the analysis and the receivables presentation guidance in ASC 606.</td>
<td>No amendments made to Example 38, Case B, in IFRS 15.</td>
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<tr>
<td>Refund liability</td>
<td>ASU 2016-20 amends Example 40 in ASC 606-10-55-293 to remove the reference to a contract liability as related to refund liabilities.</td>
<td>No amendments made to Example 40 in IFRS 15.</td>
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<td>Financial guarantee contracts</td>
<td>ASU 2016-20 clarifies that guarantee fees (other than product or service warranties) within the scope of ASC 460 are not within the scope of ASC 606.</td>
<td>No additional guidance provided. In accordance with IFRS 9, the issuer of a financial guarantee contract should initially recognize the contract at fair value and subsequently measure it at the higher of (1) the amount of the loss allowance determined in accordance with IFRS 9 or (2) the amount initially recognized less, when appropriate, the cumulative amount of income recognized in accordance with IFRS 15.</td>
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<td>Contract costs — interaction of impairment testing with guidance in other ASC topics</td>
<td>ASU 2016-20 clarifies that impairment testing on assets should be performed in the following order: (1) assets not within the scope of ASC 340, ASC 350, or ASC 360; (2) assets within the scope of ASC 340 (including contract costs capitalized under ASC 340-40); (3) asset groups and reporting units within the scope of ASC 360 and ASC 350.</td>
<td>Under IFRS 15, before an entity recognizes any impairment loss for a capitalized contract cost, it should recognize any impairment loss for assets related to the contract that are recognized in accordance with another IFRS Standard (e.g., IAS 2, IAS 16, or IAS 38). The resulting carrying amount of the asset should be included in the carrying amount of the cash-generating unit to which it belongs when IAS 36 is applied.</td>
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<td>Scope of the new revenue standard</td>
<td>ASU 2016-20 clarifies that all contracts within the scope of ASC 944 are not within the scope of ASC 606 by removing the term “insurance” from ASC 606-10-15-2(b).</td>
<td>IFRS 15 as originally issued excludes insurance contracts within the scope of IFRS 4 from the scope of IFRS 15.</td>
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<td>Advertising costs</td>
<td>ASU 2016-20 reinstates the guidance on the accrual of advertising costs that was previously in ASC 340-20 and superseded by ASU 2014-09. The reinstated guidance is in ASC 720-35.</td>
<td>No additional guidance provided.</td>
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<td>Cost capitalization for advisers to private funds and public funds</td>
<td>ASU 2016-20 amends the guidance in ASC 946-720 to align the cost capitalization guidance for advisers to both public and private funds.</td>
<td>IFRS Standards do not contain prescriptive guidance on the accounting for costs incurred by advisers to public and private funds.</td>
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<td>Fixed-odds wagering contracts in the casino industry</td>
<td>ASU 2016-20 clarifies that fixed-odds wagering contracts in the casino industry should be accounted for under the new revenue standard by providing in newly created ASC 924-815 a scope exception to the derivatives guidance.</td>
<td>The IFRS Interpretations Committee previously noted that when a gaming entity takes a position against a customer, the resulting unsettled wager is a financial instrument that is likely to meet the definition of a derivative and should therefore be accounted for under IAS 39 (or IFRS 9, if adopted). At the November 2015 TRG meeting, the IASB commented that wagering contracts that meet the definition of a financial instrument within the scope of IAS 39 or IFRS 9 are excluded from the scope of IFRS 15.</td>
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Appendix C — Summary of Issues Addressed in the FASB Staff’s Revenue Recognition Implementation Q&As and/or by the TRG

C.1 Introduction
This appendix summarizes issues addressed in the FASB staff’s January 2020 document Revenue Recognition Implementation Q&As, which contains Q&As (the “Implementation Q&As”) compiled from previously issued materials, including TRG Agenda Papers. In addition, this appendix summarizes other issues raised in TRG Agenda Papers that are not discussed in the Implementation Q&As but remain relevant to the analysis of revenue-related matters that require judgment.

The issues summarized herein are organized topically in a manner consistent with their arrangement in this Roadmap. Note that the FASB maintains a full list of questions discussed by the TRG, with links to the relevant TRG Agenda Papers.

C.2 Scope (Chapter 3 of the Roadmap)

C.2.1 Fees and Reward Programs Related to Bank-Issued Credit Cards — Implementation Q&As 1 and 2 (Compiled From TRG Agenda Papers 36 and 44)
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:

- **Credit card fees** — The FASB staff noted that all credit card fees have historically been 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 believes 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).

- **Credit card reward programs** — 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.

Outcomes under U.S. GAAP may differ from those under IFRS Standards because of differences between ASC 310 and IFRS 9.
C.2.2 Whether Fixed-Odds Wagering Contracts Are Revenue or Derivative Transactions — TRG Agenda Papers 47 and 49

Partly because of the new revenue standard's elimination of ASC 924-605 and partly because of comments that the IFRS Interpretations Committee made in its 2007 agenda decision related to accounting for fixed-odds wagering contracts, stakeholders reporting under U.S. GAAP questioned whether fixed-odds wagering 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 wording in the new revenue standard (as originally issued) did not support the staff's view. Accordingly, TRG members recommended that the Board either (1) clarify its intent to include such contracts within the scope of ASC 606 (by issuing a technical correction 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.

In December 2016, the FASB issued ASU 2016-20 on technical corrections to the new revenue standard, which includes a derivatives guidance scope exception in ASC 924 for fixed-odds wagering contracts by adding a new Codification subtopic (ASC 924-815, Entertainment — Casinos: Derivatives and Hedging) that clarifies that such contracts are revenue contracts within the scope of ASC 606. For additional information, see Chapter 3.

C.2.3 Whether Contributions Are Within the Scope of the New Revenue Standard — Implementation Q&A 6 (Compiled From TRG Agenda Papers 26 and 34)

Contributions are not explicitly excluded from the scope of the new revenue standard. 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.

If a not-for-profit entity transfers a good or service for part or all of a contribution (i.e., a reciprocal transfer), the entity should evaluate the facts and circumstances to determine whether the reciprocal transfer should be accounted for under ASC 606. As part of the evaluation, it may be helpful for the entity to evaluate how the five-step model would be applied to the transaction. An inability to identify promised goods or services or to determine when control is transferred to the counterparty may be an indicator that the transaction is not a revenue transaction with a customer.

In June 2018, the FASB issued ASU 2018-08, which provides guidance to help entities determine whether transactions are nonreciprocal contributions or exchange transactions (i.e., reciprocal transfers).

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1 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.

2 In its 2007 agenda decision (reported in the July 2007 IFRIC Update), the IFRS Interpretations Committee noted that an unsettled wager is a financial instrument that is likely to meet the definition of a derivative financial instrument under IAS 39. Currently, an entity that is required to adopt IFRS 9 should apply IFRS 9 rather than IAS 39 when accounting for derivatives.

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 IFRS Standards 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.
C.2.4 Scope Considerations for Incentive-Based Capital Allocations, Such as Carried Interests — Implementation Q&A 3 (Compiled From TRG Agenda Papers 50 and 55)

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 consideration 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).” Consequently, stakeholders have expressed the following views 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.

The Board’s view is that these arrangements are within the scope of ASC 606 because the Board regards the 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 Implementation Q&A 3 as follows:

The SEC staff observer at the TRG meeting indicated that he anticipates the SEC staff would accept an application of Topic 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 Topic 810, the equity method of accounting under Topic 323, or other relevant guidance.

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5 Quoted from paragraph 12 of TRG Agenda Paper 50.
C.2.5 Scope Considerations for Financial Institutions

To clarify which guidance applies to the fees associated with certain common financial institution transactions, the FASB staff compiled Q&As regarding whether (1) mortgage servicing rights should be accounted for under ASC 860 and (2) deposit-related fees should be accounted for under ASC 405. In addition, the TRG discussed whether fees from financial guarantees should be accounted for under ASC 460 or ASC 815.

C.2.5.1 Mortgage Servicing Rights — Implementation Q&A 4 (Compiled From TRG Agenda Papers 52 and 55)

Assets and liabilities associated with mortgage servicing rights traditionally have been accounted for under ASC 860, and such practice will not change under the new revenue standard. Servicing arrangements within the scope of ASC 860 are not within the scope of ASC 606, and ASC 860 addresses both the initial recognition and subsequent measurement of mortgage servicing assets and liabilities. In addition, because 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.

C.2.5.2 Deposit-Related Fees — Implementation Q&A 5 (Compiled From TRG Agenda Papers 52 and 55)

Entities should account for revenue from deposit-related fees in accordance with ASC 606. Financial institutions should 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 a manner similar to the application of existing SEC revenue guidance by some financial institutions to account for deposit-related fees). The FASB staff suggests 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 legacy practice would most likely be insignificant.

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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.

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).
C.2.5.3 Fees Related to Financial Guarantees — TRG Agenda Papers 52 and 55

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." 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 20.

C.3 Step 1 — Identify the Contract With the Customer (Chapter 4 of the Roadmap)

C.3.1 Contract Enforceability and Termination Clauses — Implementation Q&As 7 and 8 (Compiled From TRG Agenda Papers 10, 11, 48, and 49)

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).

The determination of whether a termination provision is substantive will require judgment and would be evaluated both quantitatively and qualitatively. 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).

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).

C.3.2 Collectibility — Implementation Q&As 9 and 10 (Compiled From TRG Agenda Papers 13 and 25)

A collectibility assessment should take the following considerations into account:

- 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.
- In determining when to reassess collectibility, an entity needs to exercise judgment on the basis of the facts and circumstances.

10 Quoted from paragraph 61 of TRG Agenda Paper 52.
In May 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.

The following issues were discussed by the TRG but are not addressed in the Implementation Q&As:

- 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.

For additional information, see Chapter 4.

C.3.3 Legal Determination of Contract Enforceability — Implementation Q&A 11

As a result of various third-party published interpretations, and because the guidance in ASC 606 refers to enforceability of rights and obligations as a matter of law, some stakeholders have raised questions about whether legal consultation is required as part of step 1. Although it is not a U.S. GAAP requirement to consult with legal counsel for all revenue contracts, it may sometimes be difficult to determine whether enforceable rights and obligations have been established (e.g., when a contract is not written). In these cases, an entity may need to perform additional steps, which may involve consultation with legal counsel, to determine whether a contract exists for purposes of ASC 606. In accordance with ASC 606-10-25-6, if the definition of a contract within the scope of ASC 606 is not met at inception, the entity should continually reassess its contract to determine whether the criteria for establishing the existence of a contract under ASC 606 are subsequently met.

C.4 Step 2 — Identify Performance Obligations (Chapter 5 of the Roadmap)

C.4.1 Immaterial Goods or Services — TRG Agenda Papers 12 and 25

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 as under legacy U.S. GAAP.
In April 2016, the FASB issued ASU 2016-10, which amends certain aspects of the new revenue standard, including the guidance on identifying performance obligations. 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.

C.4.2 Stand-Ready Obligations — Implementation Q&A 22 (Compiled From TRG Agenda Papers 16 and 25)

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.

The following broad types of promises or arrangements 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.
- **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.

The principle in the new revenue standard requires an entity to understand the nature of the promise. For example, in a contract to provide a specified number of goods or services, the nature of the promise to the customer is to provide those specified goods or services regardless of whether the customer was able to specify the timing of transfer.

Further, Type A promises (e.g., a promise in a software or biotechnology licensing arrangement to provide updates or upgrades when and if available) should be closely evaluated to determine whether, in addition to a stand-ready obligation, there are implicit promises to provide specified goods or services. An implicit promise to provide a specified good or service may result from the entity’s customary business practices, specific statements, or other communications. All facts and circumstances should be evaluated to determine the nature of the promise in the contract.

C.4.3 Distinct in the Context of the Contract — TRG Agenda Papers 9 and 11

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.

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11 ASC 606-10-25-18(e).
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 of 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 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.

C.4.4 Series of Distinct Goods or Services — Implementation Q&As 19 and 20 (Compiled From TRG Agenda Papers 27 and 34)

To promote simplicity and consistency in application, 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”). 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).

The FASB staff noted 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 Background Information and Basis for Conclusions of ASU 2014-09, the FASB staff noted that whether the pattern of performance is consecutive is not determinative of whether the series provision applies.

- The accounting result for the series of distinct goods or services as a single performance obligation does not need to be the same as if each underlying good or service were accounted for as a separate performance obligation. Implementation Q&A 20 states that “[s]uch a requirement would almost certainly make it more difficult for entities to meet the requirement, and because 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.”

12 Paragraph BC113 of ASU 2014-09.
13 ASC 606-10-25-14 and 25-15.
C.4.5 Application of the Series Provision — Implementation Q&A 18
(Compiled From TRG Agenda Papers 39 and 44)

Stakeholders raised questions related to whether performance obligations in long-term contracts meet the criteria to be accounted for under the series guidance. Implementation Q&A 18 addresses how entities should determine whether distinct goods or services are substantially the same. An entity's first step is to determine the nature of its promise of providing services to its customer. For example, an entity will need to determine whether the nature of the promise is to stand ready to perform or to provide a specified quantity of a service. If the nature of the promise is to provide a single service over a specified period or to stand ready, the evaluation would then focus on whether each time increment is distinct and substantially the same.

Implementation Q&A 18 provides four examples that illustrate the application of the framework for determining whether an entity is required to apply the series guidance. The FASB staff’s analysis of one of those examples in relation to step 2 of the new revenue standard is summarized below.

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<td>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).</td>
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C.4.6 Determining the Period Over Which an Entity Should Recognize a Nonrefundable Up-Front Fee — Implementation Q&A 52 (Compiled From TRG Agenda Papers 18, 25, 32, and 34)

A nonrefundable up-front fee (e.g., a one-time activation fee in a month-to-month service contract) 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 is related. An entity should consider both qualitative and quantitative factors to determine whether a nonrefundable up-front fee provides the customer with a material right. Factors to consider include the price a new customer would pay for the same service, availability and pricing of service alternatives, and the entity's average customer life.
C.4.7 Assessing Whether Preproduction Activities Are a Promised Good or Service — Implementation Q&A 16 (Compiled From TRG Agenda Papers 46 and 49)

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\(^\text{14}\) may be helpful in this assessment. 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).

C.4.8 Warranties — Implementation Q&A 17 (Compiled From TRG Agenda Papers 29 and 34)

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.\(^\text{15}\) 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.\(^\text{16}\)

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, the FASB staff offered 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).

The luggage example illustrates a relatively straightforward set of facts and circumstances. 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.

\(^{14}\) ASC 606-10-25-27.
\(^{15}\) ASC 606-10-32-28 through 32-41.
\(^{16}\) ASC 606-10-55-33.
C.4.9 Identifying Performance Obligations in the Franchisor Industry — Implementation Q&A 24

Before the adoption of the new revenue standard, franchisors would generally recognize initial franchise fees when the franchisee location opened in accordance with industry-specific GAAP. Under ASC 606, franchisors will need to determine whether any preopening activities represent distinct goods or services in addition to the right to use the franchisor’s IP. The transaction price is allocated to distinct goods or services on the basis of their relative stand-alone selling prices, and revenue is recognized when or as control of those distinct goods or services is transferred. There is no presumption about the number of performance obligations in a franchisor arrangement, and entities should apply judgment to individual franchisor arrangements to determine the number of performance obligations.

C.5 Step 3 — Determine the Transaction Price (Chapter 6 of the Roadmap)

C.5.1 Presentation of Amounts Billed to Customers (Gross or Net) — Implementation Q&A 27 (Compiled From TRG Agenda Papers 2 and 5)

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 accordance with ASC 606-10-32-2. 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.

An entity can apply the principal-versus-agent implementation guidance in the standard to the payments of shipping and handling fees, other out-of-pocket expenses, and taxes (by analogy) to determine whether the nature of the entity's promise is to provide the specified good or service itself or to arrange for another party to provide the good or service. The FASB staff outlined considerations related to the application of the principal-versus-agent guidance to these fees. An entity may consider whether it (1) is responsible for directly providing or procuring the service, (2) has discretion in setting the price charged (including whether the profit margin it earns is variable or fixed), and (3) bears credit risk.

An entity that elects to exclude sales taxes from the transaction price, as allowed under ASC 606-10-32-2A, is required to provide the accounting policy disclosures in ASC 235-10-50-1 through 50-6. For additional information, see Chapter 6.

C.5.2 Variable Consideration

C.5.2.1 Level of Application of the Constraint on Variable Consideration — Implementation Q&A 30 (Compiled From TRG Agenda Papers 14 and 25)

Stakeholders have questioned the unit of account for recognizing variable consideration (i.e., whether variable consideration should be assessed at the contract level or at the performance obligation level). Variable consideration is included in the transaction price if the entity concludes that it will not result in a significant revenue reversal. An entity may reach a different conclusion depending on whether the evaluation of significance is performed against the transaction price allocated to a single performance obligation or against the total contract transaction price. The evaluation of 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.
C.5.2.2 Application of the Portfolio Practical Expedient to Variable Consideration — Implementation Q&A 39 (Compiled From TRG Agenda Papers 38 and 44)

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.17

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).

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.

C.5.2.3 Application of the Variable Consideration Constraint — Implementation Q&A 40 (Compiled From TRG Agenda Papers 38 and 44)

Stakeholders have questioned whether a transaction price estimated under the expected value method can be an amount that is not a possible outcome for an individual contract. If an entity applies the expected value method by using a portfolio of data, the transaction price may be an amount that is not one of the possible outcomes because the entity is not required to switch from the expected value method to the most likely amount method when applying the constraint. However, the entity must still consider the constraint on variable consideration when determining the transaction price.

C.5.2.4 Assessing Whether a Contract Includes a Price Concession — Implementation Q&A 28 (Compiled From TRG Agenda Papers 13 and 25)

When an entity determines that it will collect less than the stated contract price, it must use judgment to determine whether this lower amount is attributable to a price concession (and should be accounted for as variable consideration) or to credit risk (which may affect the collectibility assessment as part of step 1). ASC 606-10-32-7 provides factors for an entity to consider in making this determination, including historical experience. Example 3 in ASC 606-10-55-102 through 55-105 also provides factors for an entity to consider, including (1) the customer’s intention and ability to pay and (2) the entity’s intentions and acceptance of consideration. Implementation Q&A 28 further notes that paragraph BC193 of ASU 2014-09 “discusses how an entity should consider its intentions and not only refer to past experience in assessing if a price concession has been granted to a customer.”

17 ASC 606-10-10-4.
Appendix C — Summary of Issues Addressed in the FASB Staff’s Revenue Recognition Implementation Q&As and/or by the TRG

C.5.2.5 **Accounting for an Undefined Quantity of Outputs With a Fixed Contractual Rate per Unit — Implementation Q&A 41 (Compiled From TRG Agenda Papers 39 and 44)**

The determination of whether a contract with an undefined quantity of outputs and a fixed contractual rate per unit contains variable consideration depends on an evaluation of the entity’s promise. If the promise is to provide a daily integrated service or to stand ready to deliver an undefined quantity of goods or services, the consideration is variable. If the contract includes a defined number of goods or services to be delivered at a stated rate, the consideration is not variable. Implementation Q&A 41 states that an entity should consider all substantive contractual terms, including “contractual minimums or other clauses that would make some or all of the consideration fixed.”

C.5.3 **Consideration Payable to a Customer**

C.5.3.1 **Assessing Which Payments to a Customer Are Within the Scope of the Guidance on Consideration Payable to a Customer — Implementation Q&A 25 (Compiled From TRG Agenda Papers 19, 25, 28, 34, 37, and 44)**

The TRG and the FASB staff 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).

TRG members generally 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.

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.

C.5.3.2 **Determining Who Constitute an Entity’s Customers — Implementation Q&A 26 (Compiled From TRG Agenda Papers 19, 25, 28, 34, 37, and 44)**

An entity’s customers include customers in the distribution chain and might include a customer’s customer beyond 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.

C.5.3.3 **Determining the Timing of Recognition of Variable Consideration Payable to a Customer — Implementation Q&A 29 (Compiled From TRG Agenda Papers 19, 25, 28, 34, 37, and 44)**

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.
Implementation Q&A 29 states 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 paragraph 606-10-32-25 or the date at which the consideration payable to a customer is promised in accordance with paragraph 606-10-32-27.” The determination of when the transaction price changes will require judgment. In addition, the promise to pay consideration may occur before a formal offer is made because there could be an implied promise based on customary business practice.

**C.5.3.4 Up-Front Payments to Customers and Potential Customers — Implementation Q&A 43 (Compiled From TRG Agenda Papers 59 and 60)**

The FASB staff believes that the new revenue standard is clear about the accounting for payments made to a customer when the payments are made entirely as part of a current contract with the customer. However, the FASB staff believes that the new revenue standard is less clear about the timing of recognizing an up-front payment as a reduction of revenue when either (1) a revenue contract does not exist (i.e., an entity makes a payment to incentivize the customer to enter into a revenue contract with the entity) or (2) the up-front payment is related to goods or services to be transferred under a current contract and anticipated future contracts. Accordingly, stakeholders have articulated the following two views about when an up-front payment to a customer should be recognized as a reduction of revenue:

- **View A** — Up-front payments to customers should be recognized as an asset and “amortized” as a reduction of revenue as the related goods or services are provided to the customer, which may continue beyond the current contract term.

- **View B** — Up-front payments to customers should be recognized as a reduction of revenue only over the current contract term (i.e., recognition of the up-front payment should not extend beyond the current contract term). If a contract does not exist, the up-front payments should be recognized as a reduction of revenue immediately.

View A would be appropriate in many circumstances. However, when applying View A, an entity should consider whether the payment meets the definition of an asset, which requires consideration of whether the payment results in a probable future economic benefit. Consequently, TRG members acknowledged that View B would be appropriate in some situations. The accounting for up-front payments to customers under View A or View B is not a policy election. Rather, as stated in Implementation Q&A 43, “an entity should understand the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances for each arrangement when determining the appropriate accounting.”

**C.5.4 Noncash Consideration — TRG Agenda Papers 15 and 25**

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.

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.

### C.5.5 Significant Financing Components

#### C.5.5.1 How Broadly to Interpret the Factor in ASC 606-10-32-17(c)\(^\text{18}\) — Implementation Q&A 31 (Compiled From TRG Agenda Papers 20, 25, 30, and 34)

ASC 606-10-32-17(c) does 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 will need to use judgment to evaluate the facts and circumstances of a transaction when there is a difference in timing between when goods and services are transferred and when the promised consideration is paid. An entity should consider both advance payments and payments in arrears to determine whether there is a significant financing benefit to the customer or itself. When an entity makes this assessment, it must consider whether any difference between the cash selling price and the promised consideration is proportional to the reason for the difference before concluding that the difference arises for reasons other than providing financing.

\(^{18}\) 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.”
C.5.5.2 How to Apply the Guidance When the Promised Consideration Is Equal to the Cash Selling Price — Implementation Q&A 32 (Compiled From TRG Agenda Papers 20, 25, 30, and 34)

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, a difference in those amounts does not create a presumption that a significant financing component exists; rather, it would require an evaluation.

C.5.5.3 Whether an Entity Can Account for Financing Components That Are Not Significant — Implementation Q&A 33 (Compiled From TRG Agenda Papers 30 and 34)

The new revenue standard neither requires entities to account for insignificant financing components nor precludes them from doing so.

C.5.5.4 Whether the Practical Expedient\(^1\) Can Be Applied When There Is a Single Payment Stream for Multiple Performance Obligations — Implementation Q&A 34 (Compiled From TRG Agenda Papers 30 and 34)

The FASB staff cited an example of a two-year customer contract under which an entity delivers a device at contract inception and provides a service over the two-year term, with monthly payments. 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):

- **View A** — An entity would first allocate the monthly consideration to only 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 first allocated to the device), the entity could apply the practical expedient.

- **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).

In some cases, it may be clear that cash collected is related to specific performance obligations; in other cases, that may not be clear. For the example discussed, the FASB and IASB staffs indicated in TRG Agenda Paper 30 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.

C.5.5.5 How to Calculate Interest for a Significant Financing Component — Implementation Q&A 36 (Compiled From TRG Agenda Papers 30 and 34)

The new revenue standard does not explicitly address subsequent measurement, but entities should apply the guidance in ASC 835-30.

\(^1\) 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.”
C.5.6 Accounting for Restocking Fees and Related Costs — Implementation Q&As 42 and 77 (Compiled From TRG Agenda Papers 35 and 44)

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.

An entity should include restocking fees for expected returns as part of the transaction price when control is transferred. In addition, 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).

Further, Implementation Q&A 77 states that an entity’s restocking costs for expected returns “should be recognized as a reduction of the carrying amount of the asset expected to be recovered at the point in time control of the product transfers to the customer.”

C.6 Step 4 — Allocate the Transaction Price (Chapter 7 of the Roadmap)

C.6.1 Allocating Discounts and Variable Consideration — Implementation Q&A 38 (Compiled From TRG Agenda Papers 31 and 34)

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.

C.6.2 Allocating Variable Consideration to a Series of Distinct Services — Implementation Q&A 45 (Compiled From TRG Agenda Papers 39 and 44)

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) (i.e., the series guidance).

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. A relative stand-alone selling price allocation is not required for an entity to assess whether the criteria in ASC 606-10-32-40 are met. Entities should use reasonable judgment to determine a reasonable allocation. Implementation Q&A 45 includes illustrative examples, which are summarized as follows:

• Example A — An entity provides services under a multiyear IT outsourcing arrangement with continuous delivery of various activities over the contract term. The price per unit declines over time, reflecting the expected decreasing level of effort required. In addition, price benchmarking will be performed at various points during the contract, and pricing will be updated prospectively if market prices are significantly below the contract prices. The allocation objective may be met because the pricing is based on market terms and the decreasing prices are associated with declining costs of fulfilling the obligation.
• **Example B** — An entity provides transaction processing over a multiyear term, with fees due that are based on a percentage of the dollar value processed in each transaction. The allocation objective may be met for each month of service if the fees are priced consistently throughout the contract and the rates are consistent with prices charged to other similar customers.

• **Example C** — An entity provides hotel management services during a multiyear term, with fees due that are based on (1) a percentage of monthly rental revenue, (2) reimbursement of labor costs, and (3) a percentage of gross operating profit. The fees based on monthly rental revenue in this example are similar to fees in the hotel management example in paragraph BC285 of ASU 2014-09, which are based on occupancy rates. Accordingly, those fees may meet the allocation objective for each month of service because they reflect the value transferred to the customer in each period. In addition, the reimbursement fees may meet the allocation objective if they are representative of the costs incurred to fulfill the contract each period. Further, the fees based on a percentage of gross operating profit may meet the allocation objective if they reflect the value transferred to the customer in each period.

• **Example D** — An entity provides a franchisee with the right to use its trade name and sell its products over a multiyear term. The entity will receive a sales-based royalty based on a fixed percentage of the franchisee’s sales. The allocation objective may be met because the fee earned each day is based on a consistent formula and percentage throughout the term and represents the value transferred to the customer each period.

**C.6.3 How to Apply the Significant Financing Component Guidance to Contracts With Multiple Performance Obligations — Implementation Q&A 37 (Compiled From TRG Agenda Papers 30 and 34)**

An entity will need to use judgment when attributing a significant financing component to one or more performance obligations. It may be more consistent with the overall allocation objective in ASC 606-10-32-28 to attribute the effect of a significant financing component to one or more (but not all) performance obligations in a contract by analogizing to the guidance on allocating variable consideration or to the guidance on allocating a discount.

**C.7 Step 5 — Recognize Revenue (Chapter 8 of the Roadmap)**

**C.7.1 Revenue Recognition Over Time**

Because the guidance in ASC 606-10-25-27 on recognizing revenue over time (specifically, the criterion in ASC 606-10-25-27(c)) introduces new concepts, stakeholders have raised the following issues regarding whether an entity should recognize revenue over time:

- Whether an entity that has recognized revenue at a point in time under legacy U.S. GAAP can be required to recognize revenue over time under the new revenue standard.
- Whether the alternative-use assessment in ASC 606-10-25-27(c) should be based on the completed asset or the in-production asset.
- How and when an entity should determine whether it has an enforceable right to payment in accordance with ASC 606-10-25-27(c).
C.7.1.1 Recognition of Revenue That Has Historically Been Recorded at a Point in Time — Implementation Q&A 54 (Compiled From TRG Agenda Papers 56 and 60)

Revenue from certain contracts (e.g., production-of-goods contracts) that has historically been accounted for on a point-in-time basis may need to be accounted for over time under the new revenue standard because the goods in such contracts have no alternative use to the entity and the entity has an enforceable right to payment. Each contract should be evaluated, and an entity should not presume that it will continue to recognize revenue at a point in time (or over time) because it did so under legacy revenue guidance.

C.7.1.2 Alternative-Use Assessment — Implementation Q&A 55 (Compiled From TRG Agenda Papers 56 and 60)

The alternative-use assessment should be performed at contract inception and should take into account the characteristics of the asset that will ultimately be transferred to the customer.

C.7.1.3 Enforceable Right to Payment — Implementation Q&As 56 and 57 (Compiled From TRG Agenda Papers 56 and 60)

Depending on the facts and circumstances, an enforceable right to payment may not be required before customization for the contract to qualify for revenue recognition over time (e.g., an entity need not obtain an enforceable right to payment for standardized raw materials needed in the final customized product). In such circumstances, performance on the customer's contract may begin only once those standardized raw materials are placed into the customization phase of the product. That is, for purposes of assessing whether an enforceable right to payment exists, the customer's contract may begin only when the customization commences and continues through the final completion of the product.

An entity should determine whether there is an enforceable right to payment by using the contractual terms and relevant legal precedent regardless of the entity's history or intention of enforcing those terms.

Stakeholders have noted that private companies may not have the processes and internal controls in place to obtain legal determinations for all revenue contracts. There is no requirement in the revenue standard that companies consult with legal counsel to determine whether there is an enforceable right to payment. Implementation Q&A 57 states that “[i]n the [FASB] staff’s view, a reasonable interpretation of the guidance is that when a contract's written terms do not specify the entity’s right to payment upon contract termination, an enforceable right to payment is presumed not to exist.”

C.7.2 Evaluating How Control Is Transferred Over Time — Implementation Q&A 51 (Compiled From TRG Agenda Papers 53 and 55)

Stakeholders have questioned 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. Satisfaction of any of the requirements for recognition over time implies that control is not transferred 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. This is supported by paragraphs BC125, BC128, BC130, BC131, BC135, and BC142 of ASU 2014-09, which clarify that control of any asset (such as work in progress) is transferred to the customer as progress is made.

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.
C.7.3  **Practical Expedient for Measuring Progress Toward Complete Satisfaction of a Performance Obligation — Implementation Q&A 46 (Compiled From TRG Agenda Papers 40 and 44)**

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 staff referred to 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.\(^{20}\)

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.”\(^{21}\) For the energy contract, the changing prices “reflect the value to the customer because the rates are based on one or more market indicators”;\(^{22}\) 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.”\(^{23}\)

In addition, the FASB staff 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.

C.7.4  **Measuring Progress When Multiple Goods or Services Are Included in a Single Combined Performance Obligation — Implementation Q&As 47 and 48 (Compiled From TRG Agenda Papers 41 and 44)**

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.

A common (i.e., single) measure of progress is required for a single performance obligation. 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 the selection is not a free choice. Further, 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.

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\(^{20}\) Considered in TRG Agenda Paper 40.

\(^{21}\) Quoted from paragraph BC167 of ASU 2014-09. The FASB staff 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.

\(^{22}\) Quoted from Implementation Q&A 46.

\(^{23}\) See footnote 22.
C.7.5 Partial Satisfaction of Performance Obligations Before the Contract Is Identified — Implementation Q&As 53 and 76 (Compiled From TRG Agenda Papers 33 and 34)

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 staff refers to the date on which the contract meets the step 1 criteria as the “contract establishment date” (CED) and refers to activities performed before the CED as “pre-CED activities.”

The FASB staff 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.

Once the criteria in step 1 have been met, entities should recognize revenue for pre-CED activities that transfer a good or service to the customer 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.

Certain fulfillment costs incurred before the CED are capitalized as costs of fulfilling 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.

C.7.6 Determining When Control of a Commodity Is Transferred — Implementation Q&A 50 (Compiled From TRG Agenda Papers 43 and 44)

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. 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.

Before evaluating the criteria in ASC 606-10-25-27, an entity will need to consider all relevant facts and circumstances to determine the nature of the promise to the customer in the contract. For example, the nature of a promise to deliver a commodity on demand may differ from that of a promise to deliver a specified quantity of a commodity into a customer’s storage. Implementation Q&A 50 states that the relevant facts and circumstances to be considered include “the inherent characteristics of the commodity, the contract terms, and information about infrastructure or other delivery mechanisms.”

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24 Implementation Q&A 53 states that pre-CED activities may include (1) “administrative tasks that neither result in the transfer of a good or service to the customer, nor fulfill the anticipated contract”; (2) “[a]ctivities to fulfill the anticipated contract but which do not result in the transfer of a good or service, such as set-up costs”; or (3) “[a]ctivities that transfer a good or service to the customer at or after the CED.”

25 See ASC 606-10-25-27(a).
C.7.7 Measuring Progress Toward Complete Satisfaction of a Stand-Ready Performance Obligation — Implementation Q&A 49 (Compiled From TRG Agenda Papers 16 and 25)

Although ASC 606 does not permit an entity to use by default a straight-line measure of progress based on the passage of time (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. Therefore, a time-based measure of progress is appropriate.

Implementation Q&A 49 provides additional examples of stand-ready obligations and discusses considerations related to selecting an appropriate measure of progress as follows:

- **Example A** — An entity providing helpdesk support services does not know when a customer will call and require services. The customer benefits evenly throughout the period from the availability of the service. In addition, since the entity’s costs may be fixed throughout the term regardless of the level of activity from customers, a time-based input measure of progress may also result in the same pattern of recognition.

- **Example B** — An entity providing snow removal services does not know when it will snow, and the entity’s promise is to stand ready to provide services when and if it snows. However, the entity may conclude that because the likelihood of snow will fluctuate throughout the year, it should select a more reasonable measure of progress based on its expectation of increased efforts during winter months.

- **Example C** — An entity providing a cable television service does not know when the customer will access the content by using the entity’s service. The customer benefits evenly throughout the period from the availability of the service.

Implementation Q&A 49 notes that similarly, a software vendor may provide unspecified updates or upgrades over a defined term but may not know when or to what extent they will be made available. Because the customer benefits evenly throughout the period from the promise that any updates or upgrades developed will be made available to the customer, a time-based measure of progress is generally appropriate.

C.8 Contract Modifications (Chapter 9 of the Roadmap)

C.8.1 Contract Asset Treatment in Contract Modifications — Implementation Q&A 81 (Compiled From TRG Agenda Papers 51 and 55)

Unlike legacy 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 creation of a new one. The new revenue standard also requires entities to record contract...
assets\textsuperscript{27} in certain circumstances, and these assets may still be recorded at the time of a contract modification.

When a contract modification meets the conditions in ASC 606-10-25-13(a), contract assets that existed before the modification should be carried forward to the new contract and realized as receivables\textsuperscript{28} are recognized (i.e., revenue is not reversed, leading to prospective accounting for the effects of the contract assets).

This accounting reflects the objective of ASC 606-10-25-13. As noted in Implementation Q&A 81, ASC 606-10-25-13(a)(1) “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.” Further, this accounting 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).

C.9 Principal-Versus-Agent Considerations (Chapter 10 of the Roadmap)

C.9.1 Assessing Whether an Entity Is a Principal or an Agent — (TRG Agenda Papers 1 and 5)

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.

\textsuperscript{27} ASC 606-10-45-1 through 45-5.
\textsuperscript{28} See ASC 606-10-45-4 for additional information.
In March 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 in ASU 2016-08 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. ASC 606-10-55-37, as amended by ASU 2016-08, states that “an entity is a principal if it controls the specified good or service before that good or service is transferred to a customer.”

Further, ASU 2016-08 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 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.

ASU 2016-08 does not amend the guidance in ASC 606 as originally issued to directly address the accounting for situations in which the originator has no knowledge of the amount an intermediary charges a customer for goods or services. However, paragraph BC38 of the ASU clarifies that the guidance in ASC 606 on variable consideration is helpful in the determination of what amounts should be included in the transaction price. Specifically, paragraph BC38(c) states, in part:

> 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.

For additional information, see Chapter 10.

### C.9.2 Allocation of the Transaction Price When an Entity Is a Principal for Some Goods or Services and an Agent for Others — Implementation Q&A 44 (Compiled From TRG Agenda Papers 1 and 5)

Stakeholders have questioned how the transaction price should be allocated in a contract when an entity is a principal for some promised goods or services and an agent that is arranging for the transfer of other goods or services.

First, an entity should consider whether its arrangement involves a single customer or multiple customers. If the entity identifies two or more customers, it may not be appropriate to allocate a discount to all goods or services in the contract because the contract combination guidance does not apply to contracts with more than one customer. In this scenario, the discount would be allocated entirely to one contract (e.g., in which the entity is acting as a principal).

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29 See ASC 606-10-55-37A (added by the ASU).
If there is a single customer in the arrangement (i.e., the entity is acting as both a principal and an agent in a contract with a customer), the entity will need to consider whether it can allocate the discount to one or more, but not all, performance obligations in the contract. If it does not meet the criteria to allocate the discount to one or more, but not all, performance obligations, the entity may conclude that it is appropriate to allocate the discount to all performance obligations in the contract.

C.10  Material Rights (Chapter 11 of the Roadmap)

C.10.1  Relevant Factors to Evaluate in Assessing Customer Options for Material Rights — Implementation Q&As 12 and 13 (Compiled From TRG Agenda Papers 6 and 11)

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) and (2) assess both quantitative and qualitative factors. 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, an entity would consider the fact that its customer has “earned” one-third of a free product, as well as whether the customer is likely to purchase the additional two products that would entitle it to the free product. Such an indicator may lead an entity to conclude that a customer option is a material right.

Similarly, an entity would consider loyalty programs that have an accumulation feature. Through the presence of an accumulation feature in a loyalty program, the entity may give its customers a material right. In its evaluation, the entity should consider that an element of the right granted to the customer in the current transaction is the customer’s ability to accumulate loyalty points that will entitle the customer to a free product.

C.10.2  Considering the Class of Customer in the Evaluation of Whether a Customer Option Gives Rise to a Material Right — Implementation Q&A 14 (Compiled From TRG Agenda Papers 54 and 55)

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.

30 ASC 606-10-25-2 and ASC 606-10-55-42.
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 does 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.

Implementation Q&A 14 includes three examples that illustrate the FASB staff's view on how the class of customer is considered in the evaluation of whether a customer option gives rise to a material right. The examples outline the view that an option offered to a customer should be compared with offers made to similar customers (e.g., similar high-volume customers) at prices independent of a prior contract (i.e., offers made to customers who do not have a prior contractual relationship with the entity). Significant judgment will be required to determine whether customers are comparable.

C.10.3 Distinguishing Optional Purchases From Variable Consideration — Implementation Q&A 23 (Compiled From TRG Agenda Papers 48 and 49)

Implementation Q&A 23 outlines a 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.

C.10.4 When Optional Goods and Services Would Be Considered Separate Performance Obligations — Implementation Q&A 21 (Compiled From TRG Agenda Papers 48 and 49)

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.
C.10.5  How to Evaluate a Material Right for the Existence of a Significant Financing Component — Implementation Q&A 35 (Compiled From TRG Agenda Papers 18, 25, 32, and 34)

While the determination of whether there is a significant financing component associated with a 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. In accordance with ASC 606-10-32-17(a), if the timing of when the customer will exercise an option that provides it with a material right is at the customer’s discretion, no significant financing component would exist. In addition, under the practical expedient in ASC 606-10-32-18, an entity would not adjust the transaction price for a significant financing component if the entity expects, at contract inception, that the promised good or service will be delivered within one year of customer payment.

C.10.6  Accounting for a Customer’s Exercise of a Material Right — Implementation Q&A 15 (Compiled From TRG Agenda Papers 18, 25, 32, and 34)

In Implementation Q&A 15, the FASB staff states that the guidance in ASC 606 can reasonably be interpreted to allow an entity to account for a customer’s exercise of a material right in either of the following ways:

• As a change in the contract’s transaction price31 (i.e., a continuation of the contract, whereby the additional consideration would be allocated to the performance obligation associated with the material right).

• As a contract modification32 (which may require reallocation of consideration between remaining performance obligations from the original contract and the performance obligation associated with the exercised material right).

The FASB staff adds that the entity’s chosen approach “should be applied consistently . . . to similar types of material rights with similar facts and circumstances.”

Although Implementation Q&A 15 does not discuss TRG members’ views, TRG Agenda Paper 34 notes that TRG members generally preferred that entities account for the exercise of a material right as a change in the contract’s transaction price but believed that it would be acceptable for an entity to account for the exercise of a material right as a contract modification.

31  ASC 606-10-32-42 through 32-45.
C.11 Licensing (Chapter 12 of the Roadmap)

C.11.1 Licenses of IP — TRG Agenda Papers 8 and 11

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.

In April 2016, as noted in Section C.4.1, the FASB issued ASU 2016-10, which amends certain aspects of the new revenue standard, including 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 12.

C.11.2 Licenses (Restrictions and Renewals) — TRG Agenda Papers 45 and 49

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., 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 vs. 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 12.

C.11.3 Options to Purchase or Use Additional Copies of Software — Implementation Q&A 58 (Compiled From TRG Agenda Papers 45 and 49)

Stakeholders have questioned whether options to acquire additional software users or usage of the software should be (1) subject to the sales- or usage-based royalty constraint because the variability is related to licenses of IP already transferred to the customer or (2) treated in a manner similar to the accounting for options to purchase additional goods that will be transferred at a point in time (if and when the options are exercised). If the guidance on sales- or usage-based royalties is applied, revenue would be recognized when the additional usage occurs. If the additional consideration is due as a result of an option to purchase additional goods, the entity should perform an assessment to determine whether a material right exists at contract inception. Depending on the entity's determination, a portion of the transaction price may need to be allocated to a material right.
The application of one of the above methods is not a choice; rather, it is a determination that requires judgment based on a consideration of the relevant facts and circumstances. Entities should assess whether the additional consideration is due (1) as a result of additional usage of rights already transferred to the customer or (2) only once a customer exercises an option to acquire additional rights not already transferred.

The requirement to provide additional copies of software is not determinative. Entities will need to assess whether (1) the availability of additional copies of the software is provided as a convenience to the customer and therefore represents variable consideration for rights already delivered or (2) the facts and circumstances indicate that the additional use of the software (e.g., added users) represents additional rights that the customer can obtain, which should be accounted for as an option.

C.11.4 Sales- and Usage-Based Royalties — TRG Agenda Papers 3 and 5

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 postcontract customer support, franchise licenses with training services, biotechnology and pharmaceutical licenses sold with R&D 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 related to (1) both a distinct license and nonlicense goods or services that are distinct from the license and (2) a license combined with other nonlicense goods or services in the contract (i.e., the license 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, regardless of whether the license is distinct. 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.”

C.11.4.1 Sales- or Usage-Based Royalties With a Minimum Guarantee for a License of Functional IP — Implementation Q&A 60 (Compiled From TRG Agenda Papers 58 and 60)

For licenses of functional IP, a minimum guarantee should be recognized as revenue at the point in time when the entity transfers control of the license to the customer. Any royalties that exceed the minimum guarantee should be recognized as the subsequent sales or usage occurs in accordance with ASC 606-10-55-65.
C.11.4.2  Sales- or Usage-Based Royalties With a Minimum Guarantee for a License of Symbolic IP — Implementation Q&A 59 (Compiled From TRG Agenda Papers 58 and 60)

For licenses of symbolic IP, the FASB staff articulated three views:

- **View A** — Recognize revenue as the subsequent sales or usage occurs in accordance with ASC 606-10-55-65 if the entity expects that the total royalties will exceed the minimum guarantee.
- **View B** — Estimate the transaction price (as fixed consideration plus expected royalties to be earned over the license term) and recognize revenue over time by using an appropriate measure of progress, subject to the royalty constraint.
- **View C** — Recognize the minimum guarantee over time by using an appropriate measure of progress. Once the minimum guarantee has been met, recognize the incremental royalties as the subsequent sales or usage occurs.

The new revenue standard does not require application of a single approach in all situations in which a sales- or usage-based royalty contract with a customer includes a minimum guaranteed amount of consideration and the entity expects that the royalties will exceed the guaranteed minimum. An entity should evaluate its facts and circumstances to determine which method under the standard best depicts its progress toward completion.

The three views could be reasonable interpretations of the new revenue standard, subject to the following “guard rails”:

- In the application of View A or View B, the estimated sales- or usage-based royalties must exceed the minimum guarantee.
- If View B is applied, the entity will need to periodically revisit its estimate of the total consideration (fixed and variable) and update its measure of progress accordingly, which may result in a cumulative adjustment to revenue.

C.12  Contract Costs (Chapter 13 of the Roadmap)

C.12.1  Capitalization and Amortization of Incremental Costs of Obtaining a Contract — TRG Agenda Papers 23, 25, 57, and 60

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 accounting for sales commissions is generally straightforward when (1) the commission is a fixed amount or a percentage of contract value and (2) the contract is not expected to be (or cannot be) renewed. However, if compensation plans are complex, it may be difficult to determine which costs are truly incremental and to estimate the period of amortization related to them. Examples of complex scenarios include:

- Plans with significant fringe benefits.
- Salaries based on the employee’s prior-year signed contracts.
- Commissions paid in different periods or to multiple employees for the sale of the same contract.
- Commissions based on the number of contracts the salesperson has obtained during a specific period.
- Legal and travel costs incurred in the process of obtaining a contract as well as anticipated contract renewals.

In these instances, stakeholders have questioned:

- Whether certain costs incurred to obtain a contract are incremental.
- How an entity should determine the amortization period for an asset recognized for the incremental costs of obtaining a contract with a customer, and more specifically:
  - How an entity should determine whether a sales commission is related to goods or services to be transferred under a specific anticipated contract.
  - If a sales commission is paid for an initial contract and also paid for contract renewals, how an entity should evaluate whether the sales commission paid on the contract renewal is commensurate with the sales commission paid on the initial contract.

C.12.1.1 Commission Payments Subject to Clawback — Implementation Q&As 67 and 68 (Compiled From TRG Agenda Papers 23 and 25)

Stakeholders have questioned whether commission payments that are contingent on future customer performance under the contract should be capitalized as incremental costs of obtaining a contract. If a contract has qualified for recognition under step 1 (ASC 606-10-25-1), the entity has concluded that the “parties to the contract . . . are committed to perform their respective obligations.” Therefore, the entire commission payment (or obligation, if the commission is not paid) should be capitalized at contract inception. If circumstances change over time, the entity should reassess whether there is a valid revenue contract and assess the contract cost asset for impairment.

C.12.1.2 Commissions Paid on Contract Modifications — Implementation Q&A 73 (Compiled From TRG Agenda Papers 23 and 25)

When a commission is paid on a contract modification that is not accounted for as a separate contract, the commission should still be capitalized if it is an incremental cost of obtaining a contract.

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33 Quoted from ASC 606-10-25-1(a).
C.12.1.3 Capitalization of Fringe Benefits — Implementation Q&A 74 (Compiled From TRG Agenda Papers 23, 25, 57, and 60)

When fringe benefits are incurred as a direct result of incurring the commission (such as payroll taxes or pension costs based on the incremental commission amount paid), the fringe benefits should be capitalized because they are costs “that [the entity] would not have incurred if the contract had not been obtained.”

C.12.1.4 Commissions Based on Achievement of Cumulative Targets — Implementation Q&A 69 (Compiled From TRG Agenda Papers 23 and 25)

Stakeholders have raised questions regarding the application of the new revenue standard’s cost guidance to commission plans that contain cumulative targets. For example, a salesperson may earn (1) a 5 percent commission on all contracts signed in the period if 1 through 5 contracts are signed and (2) a 10 percent commission on all contracts signed in the period if 6 through 10 contracts are signed. Implementation Q&A 69 contains examples illustrating variations of commission plans with similar cumulative targets and discusses two acceptable views on how to account for the commissions. Under those views, the commissions in the fact pattern described above may be accounted for as follows:

- **View 1** — The commission paid as a result of signing contract 6 includes the incremental 5 percent commission on contracts 1 through 5. The entity should capitalize this incremental cost upon signing contract 6. If the entity applies this view, the entity may determine that the commission it paid upon signing contract 6 should be allocated to contracts 1 through 6 for purposes of determining the period of amortization.
- **View 2** — The entity should estimate the amount of commission that will ultimately be paid for each contract and recognize that amount upon signing each contract. If the entity estimated that it would sign 7 contracts during the period, a commission of 10 percent of the value of contract 1 would be accrued upon signing.

C.12.1.5 Determining Which Costs Incurred to Obtain a Contract Are Incremental — Implementation Q&A 78 (Compiled From TRG Agenda Papers 57 and 60)

An entity should consider whether costs would have been incurred if the customer (or the entity) decided that it would not enter into the contract just as the parties were about to sign the contract. If the costs (e.g., legal costs to draft the contract) would have been incurred even though the contract was not executed, they would not be incremental costs of obtaining a contract.

The TRG cautioned that entities would need to use judgment to determine whether certain costs, such as commissions paid to multiple employees for the signing of a contract, are truly incremental. The FASB staff encouraged entities to apply additional skepticism to understand whether an employee’s compensation (i.e., commissions or bonus) — particularly for individuals in different positions in the organization and employees who are ranked higher in an organization — is related solely to executed contracts or is also influenced by other factors or metrics (e.g., employee general performance or customer satisfaction ratings). TRG members emphasized that only those costs that are incremental (i.e., the result of obtaining the contract) may be capitalized (if other asset recognition criteria are met).

34 Quoted from ASC 340-40-25-2.
Implementation Q&A 78 includes the following illustrative fact patterns and conclusions:

- **Employee salary** — An entity pays an employee an annual salary that is based on contracts signed in the prior year. The salary amount will not change on the basis of contracts signed in the current year, but salary in the subsequent year will be based on current-year contracts signed. No portion of the current-year salary should be capitalized as an incremental cost of obtaining a contract because the costs would be incurred regardless of the contracts signed in the current year.

- **Identifying incremental costs** — An entity pays an employee a 5 percent sales commission when a new contract with a customer is signed. In negotiating the contract, the entity incurs legal and travel costs. The entity should capitalize the sales commission because it is an incremental cost that the entity would not have incurred if the contract had not been signed. Because the legal and travel costs would still have been incurred if the contract had not ultimately been signed, they are not considered incremental costs of obtaining a contract and therefore should not be capitalized.

- **Timing of payment** — An employee earns a 4 percent sales commission when a new contract with a customer is signed. The entity pays half of the commission to the employee immediately upon signing, and the remaining half is paid to the employee six months later even if the employee is no longer employed by the entity at the time. The full sales commission should be capitalized upon signing because the only requirement for the employee to receive the second payment is the passage of time. There may be other fact patterns with additional contingencies to consider, including customer satisfaction surveys, incremental sales, or continued employment, which may need to be assessed further.

- **Level of employee** — When a contract with a customer is signed, an entity pays a 10 percent commission to the salesperson, a 5 percent commission to the manager, and a 3 percent commission to the regional manager. All of these commissions should be capitalized because they would not have been incurred if the contract had not been signed.

- **Payments subject to a threshold** — An entity has a sales commission plan under which the amount a salesperson receives increases on the basis of the cumulative number of contracts obtained during a period. If 0 through 9 contracts are obtained during a period, the salesperson receives no commission. If 10 through 19 contracts are obtained during a period, the salesperson receives a 2 percent commission based on the total value of contracts signed in the period. The commission costs are incremental costs of obtaining a contract, and the entity should apply other GAAP to determine whether a liability should be recognized.

### C.12.1.6 Determining the Amortization Period for the Incremental Costs of Obtaining a Contract — Implementation Q&A 79 (Compiled From TRG Agenda Papers 57 and 60)

The amortization period should reflect the period in which the entity expects to receive benefits from the underlying goods or services to which the asset is related. In estimating an amortization period, entities will need to apply judgment to determine the related goods and services and assess which contracts (i.e., initial contract and renewals) include those goods and services. An entity would need to make judgments similar to those it made when determining the amortization or depreciation period for other long-lived assets.
In Implementation Q&A 79, the FASB staff notes that although an entity’s particular facts and circumstances may support a determination that the best estimate of the amortization period is the average customer term, such term is not necessarily identical to the average period in which third parties have been customers (i.e., the average customer life). The staff observes that “[i]n most industries, the goods and services that an entity was providing two decades ago are very different from the goods and services the entity currently provides to its customers.” Since “it is unlikely that a commission paid twenty years ago has any relationship to the goods or services provided today,” it is doubtful that amortizing the commission over a period of 20 years would be consistent with the requirement in ASC 340-40-35-1 to amortize an asset “on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.”

C.12.1.7 Amortization of Commissions Paid on the Initial Contract and Renewals — Implementation Q&As 70, 71, and 72 (Compiled From TRG Agenda Papers 23, 25, 57, and 60)

When a commission plan provides an employee with a commission (that is an incremental cost) for an initial contract with a customer as well as for renewals, the costs incurred at inception (and upon renewals) should be capitalized on their respective initial (and renewal) contract inception dates because they are costs that would not have been incurred if the initial contract (and renewals) had not been obtained.

When the commission paid upon renewal is not commensurate with the commission paid for the initial contract with the customer and there are anticipated renewals, there are two acceptable alternatives for recording the amortization of the commission asset:

- Amortize the initial capitalized cost over the original contract period and the period of anticipated renewals. Amortize the capitalized costs for renewals over their respective renewal periods.

- Amortize (1) the portion of the initial capitalized cost that is equal to commissions paid upon renewal over the initial contract period and (2) the remainder over the initial contract period and anticipated renewals. Amortize the capitalized costs for renewals over their respective renewal periods.

Either of the above alternatives could be acceptable if applied consistently to similar circumstances. If there are no specifically anticipated future contracts, it would be appropriate to amortize the full contract cost at inception over the original contract term and any subsequent renewal costs over their respective terms.

To determine whether the commission paid for a contract renewal is commensurate with commissions paid for initial contracts, an entity should perform an analysis to determine whether the two commission amounts are reasonably proportional to the value of their respective contracts. The analysis should not be based on the level of effort required to obtain the initial and renewal contracts.
C.12.1.8 Determining Whether a Sales Commission Is Related to Goods or Services to Be Transferred Under a Specific Anticipated Contract — Implementation Q&A 80 (Compiled From TRG Agenda Papers 57 and 60)

The asset recognized for incremental costs of obtaining a contract may be related to goods or services under a specific anticipated contract and therefore may be amortized over the related period. If the entity expects that an initial contract will not be renewed on the basis of the relevant facts and circumstances, amortizing the asset over only the initial contract term would be an appropriate application of the new revenue standard. Alternatively, if the entity expects that renewal of the initial contract is likely, the amortization period for the asset may be longer than the initial contract term. Entities will need to evaluate the relevant facts and circumstances, including historical experience, to make a reasonable judgment.

C.12.1.9 Determining the Pattern of Amortization for a Contract Cost Asset Related to Multiple Performance Obligations — Implementation Q&A 75 (Compiled From TRG Agenda Papers 23 and 25)

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.” Stakeholders have questioned the appropriate pattern of amortization when the contract asset is related to multiple performance obligations that are satisfied over disparate points or periods. There are two views that, depending on the relevant facts and circumstances, may satisfy the requirement in the guidance:

- **View A** — The contract cost asset should be allocated in proportion to the amount of the transaction price allocated to each performance obligation and amortized on the basis of the pattern of revenue recognition for each performance obligation.

- **View B** — The contract cost asset should be amortized by using one measure of performance that best reflects the use of the asset and takes into account all performance obligations in the contract. View B would not require allocation on a relative stand-alone selling price basis, but the accounting outcomes under View A and View B should be reasonably similar.

Either approach can be applied to contract cost assets that also include specifically anticipated future contracts. In such instances, the pattern of amortization should reflect the expected pattern of revenue recognition for the initial and expected future contracts.

C.12.2 Impairment Testing of Capitalized Contract Costs — TRG Agenda Papers 4 and 5

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 as originally issued appeared to contradict itself because it also indicated that entities should apply the principles used to determine the transaction price when calculating the “amount of consideration that an entity expects to receive.” The determination of the transaction price would exclude renewals.

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35 Quoted from ASC 340-40-35-4 as originally worded.
36 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.”
Appendix C — Summary of Issues Addressed in the FASB Staff's Revenue Recognition Implementation Q&As and/or by the TRG

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.

In December 2016, as noted in Section C.2.2, the FASB issued ASU 2016-20 on technical corrections to the new revenue standard, which amends 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 13 for additional information.

C.12.3 Preproduction Activities

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 Background Information and 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 IFRS Standards.

Summarized below are 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).

C.12.3.1 Whether Entities Should Continue to Account for Certain Preproduction Costs Under ASC 340-10, and 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 — Implementation Q&A 66 (Compiled From TRG Agenda Papers 46 and 49)

Since the new revenue standard does not amend the guidance in ASC 340-10, entities that have historically accounted for preproduction costs in accordance with ASC 340-10 should continue to do so after adoption of the new revenue standard. See Chapter 3 for further developments on this matter.

After adoption of the new revenue standard, preproduction activities related to contracts historically 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 provide guidance on costs related to such contracts. However, entities should continue to account for preproduction costs related to long-term supply arrangements that are within the scope of ASC 340-10 in accordance with ASC 340-10. For additional information, see Chapters 3 and 13.
C.12.3.2 Accounting for Customer Reimbursement of Preproduction Costs — Implementation Q&A 65 (Compiled From TRG Agenda Papers 46 and 49)

Under legacy U.S. GAAP, some entities present customer reimbursements for preproduction or nonrecurring engineering costs as revenue and others as contra-expense. Under the new revenue standard, an entity will first determine whether the contract is within the scope of ASC 606. The entity will then determine whether the preproduction activities or nonrecurring engineering are a performance obligation. Depending on that determination, the reimbursement for the costs is accounted for as follows:

- If the preproduction activities are a set-up or administrative task that does not transfer a good or service, the reimbursement is included in the transaction price and recognized as control of the related production units is transferred.
- If the preproduction activities are a distinct performance obligation, the reimbursement is recognized as revenue when or as control is transferred.
- If the preproduction activities are part of a combined performance obligation, the reimbursement is included in the transaction price and recognized by using a single measure of progress for the combined single performance obligation.

C.12.4 Accounting for Reimbursements From Customers for Out-of-Pocket Expenses — Implementation Q&A 64

Because the new revenue standard does not contain any guidance that explicitly addresses the accounting for reimbursement from customers of out-of-pocket expenses, the FASB staff decided to address key considerations related to that issue in Implementation Q&A 64. Specifically, stakeholders have questioned when an entity would be required to estimate reimbursements for out-of-pocket expenses from customers as a form of variable consideration. Implementation Q&A 64 includes analysis of the guidance on variable consideration and notes that variable consideration would not need to be estimated in the following circumstances:

- The entity is an agent with respect to the performance obligation.
- The variable consideration is fully constrained on the basis of an analysis of the entity's facts and circumstances.
- The variable consideration is related to a performance obligation or to distinct good or service in a series, and allocating the consideration to the specific good or service would meet the allocation objective.
- The entity recognizes the related revenue over time and applies either (1) the “as invoiced” practical expedient or (2) an input cost-to-cost method.

Although materiality is not specifically contemplated in the accounting guidance, Implementation Q&A 64 also notes that in the FASB staff's view, an entity may be able to conclude in many circumstances that the impact of out-of-pocket reimbursements is immaterial.
Appendix C — Summary of Issues Addressed in the FASB Staff’s Revenue Recognition Implementation Q&As and/or by the TRG

C.13  Presentation (Chapter 14 of the Roadmap)

C.13.1  Presentation of Contract Assets and Contract Liabilities — Implementation Q&As 61, 62, and 63 (Compiled From TRG Agenda Papers 7 and 11)

Although certain types of assets and liabilities result from revenue arrangements under legacy U.S. 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 contract, and not individual performance obligations, is the appropriate unit of account for presenting contract assets and contract liabilities.
- Presenting contract assets and contract liabilities for individual contracts — Contract assets or contract liabilities should be presented for each contract on a net basis.
- Presenting contract assets and contract liabilities for combined contracts — When contracts meet the requirement for combination under the new revenue standard, a net contract asset or net contract liability should be presented for the combined contract.
- Offsetting other assets and contract liabilities against contract assets and contract liabilities — Entities should look to existing guidance to determine whether they have the right of offset.  

C.14  Effective Date and Transition (Chapter 16 of the Roadmap)

C.14.1  Contract Modifications at Transition — TRG Agenda Papers 24 and 25

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 — 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.

In May 2016, as noted in Section C.3.2, 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 full 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 16.

37 ASC 210-20.
38 As used in ASC 250.
C.14.2 Completed Contracts at Transition — TRG Agenda Papers 42 and 44

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 legacy 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.39

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 16.

39 It was noted that these issues pertain primarily to U.S. GAAP but that similar issues could arise under IFRS Standards.
Appendix D — Roadmap for Implementation

D.1 Overview
Although public business entities (PBEs) have already adopted the new revenue standard, certain entities that are not PBEs (or certain emerging growth companies (EGCs) that have elected to adopt ASC 606 by using the non-PBE effective date) may still be transitioning to the standard. For example, certain entities that are not PBEs and have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, may elect to adopt the new revenue standard for annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020.

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.
### D.2 Illustrative Roadmap

<table>
<thead>
<tr>
<th>Activity</th>
<th>Standard Effective</th>
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</thead>
<tbody>
<tr>
<td>Risk assessment</td>
<td>Perform risk assessment</td>
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<tr>
<td><strong>Technical accounting</strong></td>
<td></td>
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<tr>
<td>Understand the standard</td>
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<tr>
<td>Identify contracts</td>
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<tr>
<td>Perform contract evaluations</td>
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<td>Develop accounting policy documentation</td>
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<tr>
<td>Auditor review of contract/policy</td>
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<tr>
<td>Draft disclosures</td>
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<td>Finalize transition plan</td>
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<td><strong>Data and system development</strong></td>
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<td>Data retention strategy</td>
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<td>Systems architecture options</td>
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<tr>
<td>Execute data retention strategy</td>
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<tr>
<td>Develop accounting rules</td>
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<tr>
<td>Test accounting rules</td>
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<tr>
<td>Postimplementation review</td>
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<tr>
<td><strong>Process/close, consolidate, and report</strong></td>
<td>Consider existing disclosures</td>
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<tr>
<td>Consider COSO principles</td>
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<tr>
<td>Design infrequent event controls</td>
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<tr>
<td>Monthly close processes/staffing</td>
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<tr>
<td>Control implementation review</td>
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<tr>
<td><strong>Tax compliance and accounting</strong></td>
<td>Evaluate tax reporting requirements</td>
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<tr>
<td><strong>Readiness and training</strong></td>
<td>Tax reporting implementation</td>
</tr>
<tr>
<td>Hold initial training sessions</td>
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<tr>
<td>Develop training sessions</td>
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<tr>
<td>Training rollout</td>
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<tr>
<td><strong>Program management</strong></td>
<td>Develop program management plan</td>
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<tr>
<td><strong>Sustainability</strong></td>
<td>Periodic steering committee updates</td>
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</tbody>
</table>

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*Note: The diagram is a visual representation of the illustrative roadmap, detailing the activities and sub-activities across the Understanding, Education, Assessment, Implementation, and Sustainability phases.*
### D.3 Understanding, Education, and Planning

**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 white papers, accounting policies, narratives, and process flows to understand existing 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 existing disclosures | • Determine necessary disclosures under SAB 74 (codified in SAB Topic 11.M).¹
| • Identify existing revenue recognition disclosures (both annual and interim disclosures) 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 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?

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¹ Although the majority of SEC registrants have already adopted ASC 606, certain EGCs that have elected to adopt the new revenue standard by using the non-PBE effective date may still need to consider the applicable SAB 74 disclosures in upcoming financial statements.
(Table continued)

<table>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
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</thead>
</table>
| Readiness and Training            | • Hold initial training sessions 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 resource estimates for the 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 any issues being deliberated by the FASB, SEC, PCAOB, AICPA, EITF, and relevant industry task forces.  
• Participate in industry roundtables to understand how industry-specific issues are being addressed. |

D.4 Assessment

<table>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
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</thead>
<tbody>
<tr>
<td>Risk Assessment</td>
<td>Perform risk assessment related to the adoption of the new revenue standard throughout the adoption activities.</td>
</tr>
</tbody>
</table>
### Technical Accounting

**Activities**

- 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 each contract type.
  - 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>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
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</thead>
<tbody>
<tr>
<td><strong>Technical Accounting</strong></td>
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<tr>
<td>Develop accounting policy documentation</td>
<td>• Evaluate primary accounting issues, and research relevant requirements for tentative conclusions.</td>
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<td></td>
<td>• Evaluate the accounting impact of complex arrangements, and draft related white papers.</td>
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<td>• Develop accounting policy and position documentation, and share with external auditors for continuous feedback.</td>
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<tr>
<td>Finalize transition plan</td>
<td>• Draft illustrative impact on financial statements and key metrics.</td>
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<td>• Establish implementation timelines across all regions and sectors, including:</td>
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<td></td>
<td>○ Identifying resource requirements and resources to fulfill those requirements.</td>
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<td></td>
<td>○ Identifying key milestones and dates for meeting those milestones.</td>
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<td></td>
<td>• Communicate implementation timeline across all regions and sectors, and finalize timeline for implementation.</td>
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<tr>
<td><strong>Data and System Development</strong></td>
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<tr>
<td>Determine data retention and strategy</td>
<td>• Identify data gaps and related data to be tracked and retained for accounting purposes upon implementation of the standard.</td>
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<td>• Communicate data tracking and retention requirements to all offices and regions.</td>
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<td>• Develop processes and controls to ensure that data that are being collected and maintained are complete and usable.</td>
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<tr>
<td>Identify systems architecture options</td>
<td>• Coordinate with IT and finance to understand requirements locally and across all regions and business units.</td>
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<td>• Identify key data sources.</td>
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<td>• Perform data gap analysis and sourcing of key data.</td>
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<td>• Consider alternatives to start storing key data for future accounting before systems development is completed.</td>
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<td>• Evaluate impact of data volume and calculation requirements on database architecture.</td>
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<td>• Identify preliminary solution recommendation that contemplates all regions and business units.</td>
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<td>Develop accounting rules and business requirements</td>
<td>• Develop business requirements document.</td>
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<td>• Review functional and business specifications with IT.</td>
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<td>• Prepare functional and technical design document for solution building and development.</td>
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<td>• Design artifacts development, including application interface.</td>
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<td>• Conduct business reviews of design and architecture deliverables.</td>
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</table>
### Appendix D — Roadmap for Implementation

<table>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
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<tr>
<td><strong>Process/Close, Consolidate, and Report</strong></td>
<td></td>
</tr>
<tr>
<td>Consider existing disclosures</td>
<td>Determine necessary disclosures under SAB 74 (codified in SAB Topic 11.M).²</td>
</tr>
<tr>
<td>Design infrequent event controls</td>
<td>• Design controls to address risks of material misstatement arising from the adoption of the new revenue standard.</td>
</tr>
<tr>
<td></td>
<td>• Reevaluate the design of existing controls that address the risks of material misstatement related to the revenue assertions, as applicable.</td>
</tr>
<tr>
<td><strong>Tax Compliance and Accounting</strong></td>
<td></td>
</tr>
<tr>
<td>Evaluate tax reporting requirements</td>
<td>• Review sample accounting calculation logic, journal entries, and other analytical reports from contract evaluations.</td>
</tr>
<tr>
<td></td>
<td>• Identify specific tax reporting requirements across all regions and business units.</td>
</tr>
<tr>
<td></td>
<td>• Evaluate tax filing and reporting implications of revenue changes.</td>
</tr>
<tr>
<td></td>
<td>• Document tax conclusions and tax accounting policies.</td>
</tr>
<tr>
<td></td>
<td>• Develop a plan for tax data maintenance, and document tax data flows.</td>
</tr>
<tr>
<td></td>
<td>• Evaluate potential integration issues and possible modification needs with tax accounting systems.</td>
</tr>
<tr>
<td></td>
<td>• Integrate tax requirements into overall transition plan.</td>
</tr>
<tr>
<td><strong>Readiness and Training</strong></td>
<td></td>
</tr>
<tr>
<td>Develop training sessions</td>
<td>• Identify audience, timing, frequency, and duration of training.</td>
</tr>
<tr>
<td></td>
<td>• Develop training plan and materials.</td>
</tr>
<tr>
<td></td>
<td>• Tailor training material for different business needs and audiences.</td>
</tr>
<tr>
<td><strong>Program Management and Communications</strong></td>
<td></td>
</tr>
<tr>
<td>Update steering committee</td>
<td>• Conduct periodic status meetings with key project personnel.</td>
</tr>
<tr>
<td></td>
<td>• Provide periodic status reports.</td>
</tr>
<tr>
<td></td>
<td>• Provide overview of significant accounting, financial reporting, and system impact and changes under the new revenue standard.</td>
</tr>
<tr>
<td></td>
<td>• Periodically update project overview and progress:</td>
</tr>
<tr>
<td></td>
<td>• Management of progress against work plan.</td>
</tr>
<tr>
<td></td>
<td>• Discussion and remediation of risks.</td>
</tr>
<tr>
<td></td>
<td>• Stay up to date on any issues being deliberated by the FASB, SEC, PCAOB, AICPA, EITF, and relevant industry task forces.</td>
</tr>
<tr>
<td></td>
<td>• Participate in industry roundtables to understand how industry-specific issues are being addressed.</td>
</tr>
<tr>
<td></td>
<td>• Conduct periodic status meetings with external auditors, those charged with governance (e.g., the audit committee, board of directors), and other constituents, as applicable.</td>
</tr>
</tbody>
</table>

² See footnote 1.
## D.5 Implementation

<table>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Assessment</strong></td>
<td></td>
</tr>
<tr>
<td>Perform risk assessment</td>
<td>Perform risk assessment related to the adoption of the new revenue standard throughout the adoption activities.</td>
</tr>
<tr>
<td><strong>Technical Accounting</strong></td>
<td></td>
</tr>
</tbody>
</table>
| 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 74 (codified in SAB Topic 11.M).  
• 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)

<table>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Data and System Development</strong></td>
<td></td>
</tr>
<tr>
<td>Test accounting rules</td>
<td>Test modifications made to accounting systems or implementation(s) of new revenue accounting system(s), and remediate any identified errors.</td>
</tr>
<tr>
<td>Deployment</td>
<td>• Deploy system into production.</td>
</tr>
<tr>
<td></td>
<td>• Run portfolio reports to facilitate debugging, reconciliations, and remediation.</td>
</tr>
<tr>
<td>Postimplementation review</td>
<td>Run/test dual reporting functionality to debug in advance of the standard's effective date.</td>
</tr>
<tr>
<td><strong>Process/Close, Consolidate, and Report</strong></td>
<td></td>
</tr>
<tr>
<td>Consider existing disclosures</td>
<td>Determine necessary disclosures under SAB 74 (codified in SAB Topic 11.M).</td>
</tr>
<tr>
<td>Monthly close processes/staffing</td>
<td>• Identify additional steps required in periodic closing process on the basis of the system functionality implemented.</td>
</tr>
<tr>
<td></td>
<td>• Evaluate (1) additional processes and resource needs and (2) revised job requirements.</td>
</tr>
<tr>
<td></td>
<td>• Define systems/data needs or customized reports to support periodic management and corporate reporting purposes, including review cycles.</td>
</tr>
<tr>
<td></td>
<td>• Document periodic reporting policy and procedure.</td>
</tr>
<tr>
<td>Control implementation review</td>
<td>• Document reporting processes and procedures related to new revenue calculations and reports.</td>
</tr>
<tr>
<td></td>
<td>• Review operation of key controls, processes, and reports on potential improvement.</td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
</tr>
<tr>
<td><strong>Tax Compliance and Accounting</strong></td>
<td></td>
</tr>
<tr>
<td>Tax reporting implementation</td>
<td>• Develop testing procedures for system integration.</td>
</tr>
<tr>
<td></td>
<td>• Evaluate system solution for adequacy in addressing accounting and reporting needs under the new revenue standard.</td>
</tr>
<tr>
<td></td>
<td>• Test modifications/implementation of IT system(s) and error remediation for revised tax reporting requirements.</td>
</tr>
<tr>
<td></td>
<td>• Develop and execute tax training session.</td>
</tr>
<tr>
<td><strong>Readiness and Training</strong></td>
<td></td>
</tr>
<tr>
<td>Training rollout</td>
<td>• Execute training sessions.</td>
</tr>
<tr>
<td></td>
<td>• Perform ongoing enhancements to training materials, as necessary.</td>
</tr>
</tbody>
</table>

^4 See footnote 1.
(Table continued)

<table>
<thead>
<tr>
<th>Activities</th>
<th>Key Actions</th>
</tr>
</thead>
</table>
| Program Management        | • 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 any issues being deliberated by the FASB, 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.  

D.6 Sustainability

Understanding, Education, and Planning >> Assessment >> Implementation >> 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.

• Monitor SEC, FASB, and other stakeholder activities (see Chapter 20), as well as review comment letters issued by the SEC staff regarding comparable entities’ ASC 606 disclosures, to identify potential modifications to disclosures.

• Issue Forms 10-Q and 10-K, if applicable, with expanded disclosures.
Appendix E — Titles of Standards and Other Literature

**AICPA Literature**

**Audit and Accounting Guide**

*Revenue Recognition*

**FASB Literature**

**ASC Topics**

ASC 210, *Balance Sheet*
ASC 220, *Income Statement — Reporting Comprehensive Income*
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 320, *Investments — Debt Securities*
ASC 321, *Investments — Equity Securities*
ASC 323, *Investments — Equity Method and Joint Ventures*
ASC 325, *Investments — Other*
ASC 326, *Financial Instruments — Credit Losses*
ASC 330, *Inventory*
ASC 340, *Other Assets and Deferred Costs*
ASC 350, *Intangibles — Goodwill and Other*
ASC 360, *Property, Plant, and Equipment*
ASC 405, *Liabilities*
ASC 450, *Contingencies*
ASC 460, *Guarantees*
ASC 470, Debt
ASC 505, Equity
ASC 605, Revenue Recognition
ASC 606, Revenue From Contracts With Customers
ASC 610, Other Income
ASC 705, Cost of Sales and Services
ASC 710, Compensation — General
ASC 712, Compensation — Nonretirement Postemployment Benefits
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 720, Other Expenses
ASC 730, Research and Development
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 808, Collaborative Arrangements
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 835, Interest
ASC 840, Leases
ASC 842, Leases
ASC 845, Nonmonetary Transactions
ASC 855, Subsequent Events
ASC 860, Transfers and Servicing
ASC 908, Airlines
ASC 912, Contractors — Federal Government
ASC 924, Entertainment — Casinos
ASC 926, Entertainment — Films
ASC 932, Extractive Activities — Oil and Gas
ASC 942, Financial Services — Depository and Lending
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies
Appendix E — Titles of Standards and Other Literature

ASC 952, Franchisors

ASC 954, Health Care Entities

ASC 958, Not-for-Profit Entities

ASC 970, Real Estate — General

ASC 980, Regulated Operations

ASC 985, Software

**ASUs**

ASU 2013-12, *Definition of a Public Business Entity — An Addition to the Master Glossary*

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

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 2015-02, *Consolidation (Topic 810)*

ASU 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*


ASU 2016-02, *Leases (Topic 842)*

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 2016-11, *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 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers*

ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

ASU 2017-05, *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*

ASU 2017-13, *Revenue Recognition (Topic 605), Revenue From Contracts With Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Recision of Prior SEC Staff Announcements and Observer Comments*

ASU 2017-14, *Income Statement — Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue From Contracts With Customers (Topic 606): Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 116 and SEC Release No. 33-10403*
ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

ASU 2018-08, Not-for-Profit Entities (Topic 958): Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made

ASU 2018-11, Leases (Topic 842): Targeted Improvements

ASU 2018-18, Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606

ASU 2019-08, Financial Services — Insurance (Topic 944): Effective Date

ASU 2020-05, Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities

**Proposed ASUs**

Proposed ASU 1820-100, Revenue Recognition (Topic 605): Revenue From Contracts With Customers

Proposed ASU 2011-230 (Revised), Revenue Recognition (Topic 605): Revenue From Contracts With Customers

**IFRS Literature**

IFRS 4, Insurance Contracts

IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations

IFRS 9, Financial Instruments

IFRS 10, Consolidated Financial Statements

IFRS 11, Joint Arrangements

IFRS 15, Revenue From Contracts With Customers

IAS 2, Inventories

IAS 10, Events After the Reporting Period

IAS 11, Construction Contracts

IAS 18, Revenue

IAS 34, Interim Financial Reporting

IAS 36, Impairment of Assets

IAS 37, Provisions, Contingent Liabilities and Contingent Assets

IAS 38, Intangible Assets

IAS 39, Financial Instruments: Recognition and Measurement

**IRC**

Section 451, “General Rule for Taxable Year of Inclusion”

- Section 451(b), “Inclusion Not Later Than for Financial Accounting Purposes”
- Section 451(c), “Treatment of Advance Payments”
Section 460, “Special Rules for Long-Term Contracts”

Section 481(a), “Adjustments Required by Changes in Method of Accounting: General Rule”

**SEC Literature**

**FRM**

Topic 1, “Registrant’s Financial Statements”; Section 1500, “Interim Period Reporting Considerations (All Filings)”

Topic 2, “Other Financial Statements Required”; Section 2410, “Measuring Significance of Equity Method Investees Under S-X 3-09”

Topic 3, “Pro Forma Financial Information”; Section 3250, “In Business Combinations”

Topic 10, “Emerging Growth Companies”; Section 10110, “Eligibility as an EGC”; Section 10230, “Accounting Standards Transition Period Accommodation”

Topic 11, “Reporting Issues Related to Adoption of New Accounting Standards”; Section 11110, “Registrant Financial Information”; Section 11120, “Financial Statements of Other Entities and Significance”

Topic 13, “Effects of Subsequent Events on Financial Statements Required in Filings”; Section 13100, “General”; Section 13200, “Discontinued Operations”

**Final Rule**


No. 33-10786, *Amendments to Financial Disclosures About Acquired and Disposed Businesses*

No. 33-10825, *Modernization of Regulation S-K Items 101, 103, and 105*

**Interpretive Release**

No. 33-10403, *Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement Into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*

**Proposed Rule**

No. 33-10750, *Management’s Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information*

**Regulation S-K**

Item 101, “Description of Business”

Item 101(c), “Narrative Description of Business”

Item 103, “Legal Proceedings”

Item 105, “Risk Factors”

Item 301, “Selected Financial Data”

Item 302(a), “Supplementary Financial Information: Selected Quarterly Financial Data”

Item 512(a), “Undertakings: Rule 415 Offering”

Item 601(b), “Exhibits: Description of Exhibits”

**Regulation S-X**

Rule 1-02(w), “Definitions of Terms Used in Regulation S-X: Significant Subsidiary”

Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”

Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired”

Rule 4-08, “General Notes to Financial Statements”

Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Rule 5-03, “Statements of Comprehensive Income”

Rule 5-04, “What Schedules Are to Be Filed”

Article 10, “Interim Financial Statements”

Rule 10-01(a), “Condensed Statements”

Article 11, “Pro Forma Financial Information”

Rule 12-09, “Valuation and Qualifying Accounts”

**SAB Topics**

SAB Topic 1.M, “Materiality”

SAB Topic 8, “Retail Companies”

SAB Topic 8.A, “Sales of Leased or Licensed Departments”


SAB Topic 13, “Revenue Recognition”


SAB Topic 13.A.2, “Persuasive Evidence of an Arrangement”


SAB No. 101, “Revenue Recognition in Financial Statements”

SAB No. 104, “Revenue Recognition, Corrected Copy”
Other Literature

United States Code
Title 17, “Copyrights”; Chapter 1, “Subject Matter and Scope of Copyright”; Section 109, “Limitations on Exclusive Rights: Effect of Transfer of Particular Copy or Phonorecord”

TRG Agenda Papers
TRG Agenda Paper 1, Gross Versus Net Revenue
TRG Agenda Paper 2, Gross Versus Net Revenue: Amounts Billed to Customers
TRG Agenda Paper 3, Sales-Based and Usage-Based Royalties in Contracts With Licenses and Goods or Services Other Than Licenses
TRG Agenda Paper 4, Impairment Testing of Capitalised Contract Costs
TRG Agenda Paper 5, July 2014 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 6, Customer Options for Additional Goods and Services and Nonrefundable Upfront Fees
TRG Agenda Paper 7, Presentation of a Contract as a Contract Asset or a Contract Liability
TRG Agenda Paper 8, Determining the Nature of a License of Intellectual Property
TRG Agenda Paper 9, Distinct in the Context of the Contract
TRG Agenda Paper 10, Contract Enforceability and Termination Clauses
TRG Agenda Paper 11, October 2014 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 12, Identifying Promised Goods or Services in a Contract With a Customer
TRG Agenda Paper 13, Collectibility
TRG Agenda Paper 14, Variable Consideration
TRG Agenda Paper 15, Noncash Consideration
TRG Agenda Paper 16, Stand-Ready Performance Obligations
TRG Agenda Paper 18, Material Right
TRG Agenda Paper 19, Consideration Payable to a Customer
TRG Agenda Paper 20, Significant Financing Components
TRG Agenda Paper 23, Incremental Costs of Obtaining a Contract
TRG Agenda Paper 24, Evaluating Contract Modifications Prior to the Date of Initial Application
TRG Agenda Paper 25, January 2015 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 26, Whether Contributions Are Included or Excluded From the Scope
TRG Agenda Paper 27, Series of Distinct Goods or Services
TRG Agenda Paper 28, Consideration Payable to a Customer
TRG Agenda Paper 29, Warranties
TRG Agenda Paper 30, Significant Financing Components
TRG Agenda Paper 31, Allocation of the Transaction Price for Discounts and Variable Consideration
TRG Agenda Paper 32, Accounting for a Customer’s Exercise of a Material Right
TRG Agenda Paper 33, Partial Satisfaction of Performance Obligations Prior to Identifying the Contract
TRG Agenda Paper 34, March 2015 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 35, Accounting for Restocking Fees and Related Costs
TRG Agenda Paper 36, Scope: Credit Cards
TRG Agenda Paper 37, Consideration Payable to a Customer
TRG Agenda Paper 38, Portfolio Practical Expedient and Application of Variable Consideration Constraint
TRG Agenda Paper 39, Application of the Series Provision and Allocation of Variable Consideration
TRG Agenda Paper 40, Practical Expedient for Measuring Progress Toward Complete Satisfaction of a Performance Obligation
TRG Agenda Paper 41, Measuring Progress When Multiple Goods or Services Are Included in a Single Performance Obligation
TRG Agenda Paper 42, Completed Contracts at Transition
TRG Agenda Paper 43, Determining When Control of a Commodity Transfers
TRG Agenda Paper 44, July 2015 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 45, Licenses — Specific Application Issues About Restrictions and Renewals
TRG Agenda Paper 46, Pre-Production Activities
TRG Agenda Paper 47, Whether Fixed Odds Wagering Contracts Are Included or Excluded From the Scope of Topic 606
TRG Agenda Paper 48, Customer Options for Additional Goods and Services
TRG Agenda Paper 49, November 2015 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 50, Scoping Considerations for Incentive-Based Capital Allocations, Such as Carried Interest
TRG Agenda Paper 51, Contract Asset Treatment in Contract Modifications
TRG Agenda Paper 52, Scoping Considerations for Financial Institutions
TRG Agenda Paper 53, Evaluating How Control Transfers Over Time
TRG Agenda Paper 54, Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right
TRG Agenda Paper 55, April 2016 Meeting — Summary of Issues Discussed and Next Steps
TRG Agenda Paper 56, Over Time Revenue Recognition
TRG Agenda Paper 57, Capitalization and Amortization of Incremental Costs of Obtaining a Contract
TRG Agenda Paper 58, Sales-Based or Usage-Based Royalty With Minimum Guarantee
TRG Agenda Paper 59, Payments to Customers
TRG Agenda Paper 60, November 2016 Meeting — Summary of Issues Discussed and Next Steps
Superseded Literature

AICPA Statements of Position
81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts
97-2, Software Revenue Recognition
00-2, Accounting by Producers or Distributors of Films

EITF Issues
Topic D-96, “Accounting for Management Fees Based on a Formula”
90-22, “Accounting for Gas-Balancing Arrangements”
91-9, “Revenue and Expense Recognition for Freight Services in Process”
99-19, “Reporting Revenue Gross as a Principal Versus Net as an Agent”
00-10, “Accounting for Shipping and Handling Fees and Costs”
01-8, “Determining Whether an Arrangement Contains a Lease”
01-9, “Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor’s Products)”
01-14, “Income Statement Characterization of Reimbursements Received for ‘Out-of-Pocket’ Expenses Incurred”
02-16, “Accounting by a Customer (Including a Reseller) for Certain Consideration Received From a Vendor”
08-2, “Lessor Revenue Recognition for Maintenance Services”

FASB Concepts Statements
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 Statement of Financial Accounting Standards
No. 5, Accounting for Contingencies
No. 45, Accounting for Franchise Fee Revenue
No. 48, Revenue Recognition When Right of Return Exists
No. 66, Accounting for Sales of Real Estate
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

FASB Technical Bulletin
No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts
# Appendix F — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AI</td>
<td>artificial intelligence</td>
</tr>
<tr>
<td>AFS</td>
<td>applicable finance statement</td>
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<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>B&amp;E</td>
<td>blend-and-extend</td>
</tr>
<tr>
<td>BC</td>
<td>Basis for Conclusions</td>
</tr>
<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
</tr>
<tr>
<td>CAM</td>
<td>common area maintenance</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CED</td>
<td>contract establishment date</td>
</tr>
<tr>
<td>CODM</td>
<td>chief operating decision maker</td>
</tr>
<tr>
<td>COSO</td>
<td>Committee of Sponsoring Organizations of the Treadway Commission</td>
</tr>
<tr>
<td>CRM</td>
<td>customer relationship management</td>
</tr>
<tr>
<td>DTA</td>
<td>deferred tax asset</td>
</tr>
<tr>
<td>DTL</td>
<td>deferred tax liability</td>
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<tr>
<td>EAC</td>
<td>estimated total costs at completion</td>
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<td>ED</td>
<td>exposure draft</td>
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<td>EGC</td>
<td>emerging growth company</td>
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<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>ERP</td>
<td>enterprise resource planning</td>
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<tr>
<td>FAS</td>
<td>FASB Statement of Financial Accounting Standards</td>
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<td>FASB</td>
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<td>FOB</td>
<td>free on board</td>
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<td>FRM</td>
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<td>IAS</td>
<td>International Accounting Standard</td>
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<td>Management's Discussion and Analysis</td>
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<td>power and utilities</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>PCS</td>
<td>postcontract customer support</td>
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<td>Abbreviation</td>
<td>Description</td>
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<td>Q&amp;A</td>
<td>question and answer</td>
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<td>Sarbanes-Oxley Act of 2002</td>
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<td>TCJA</td>
<td>Tax Cuts and Jobs Act</td>
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<td>TRG</td>
<td>FASB/IASB transition resource group for revenue recognition</td>
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<td>UCC</td>
<td>Uniform Commercial Code</td>
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<td>VSOE</td>
<td>vendor-specific objective evidence</td>
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</table>
Appendix G — Changes Made in the 2020 Edition of This Publication

Much of the content in the 2020 edition of this Roadmap has been reorganized for presentation in a more user-friendly manner. Significant changes include (1) reformatting the Q&As of last year’s edition as narrative text; (2) removing TRG Update symbols and incorporating the related content into the narrative text; (3) adding references to the FASB staff’s Revenue Recognition Implementation Q&As (the “Implementation Q&As”) issued in January 2020; (4) creating a separate Chapter 11 — Customer Options for Additional Goods or Services (Material Rights) by relocating content from various existing chapters in the Roadmap; and (5) relocating other content from various existing chapters.

The key changes made since publication of the 2019 edition of this Roadmap are summarized in the tables below.

### New Content

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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<tbody>
<tr>
<td>3.2.9</td>
<td>Collaborative Arrangements</td>
<td>Added a discussion on whether collaboration arrangements with third parties meet the U.S. GAAP definition of a collaborative arrangement that is subject to the requirements of ASC 808.</td>
</tr>
<tr>
<td>5.3.2.2.3</td>
<td>Goods or Services Are Highly Interdependent or Interrelated</td>
<td>Added an excerpt from OCA Professional Accounting Fellow Susan Mercier’s speech at the 2019 AICPA Conference on Current SEC and PCAOB Developments.</td>
</tr>
<tr>
<td>6.6.1.1</td>
<td>Identifying Customers Within the Scope of the Requirements Related to Consideration Payable to a Customer</td>
<td>Added a discussion explaining that contractual linkage is not necessarily required for an incentive payment to be treated as consideration payable to a customer.</td>
</tr>
<tr>
<td>6.6.2.5</td>
<td>Applying the Guidance on Consideration Received From a Vendor</td>
<td>Added Changing Lanes — Consideration Received From a Vendor, which notes that while ASC 705-20 retains the “separate identified benefit” concept from ASC 605-50, ASC 705-20 does not require the distinct good or service to have a readily determinable fair value.</td>
</tr>
<tr>
<td>6.7</td>
<td>Sales Taxes and Similar Taxes Collected From Customers</td>
<td>Added Changing Lanes — Sales Taxes, which notes that while the scope of sales taxes in the new revenue standard aligns with that in ASC 605-45-15-2(e) under legacy U.S. GAAP, the policy election is different.</td>
</tr>
<tr>
<td>Section</td>
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<tr>
<td>10.2.2</td>
<td>Controlling the Right to a Service</td>
<td>Added an excerpt from OCA Professional Accounting Fellow Lauren Alexander’s speech at the 2019 AICPA Conference on Current SEC and PCAOB Developments.</td>
</tr>
<tr>
<td>10.2.4.1</td>
<td>Primary Responsibility</td>
<td>Added interpretive guidance expressing our view that if it is clear that an entity has primary responsibility for fulfilling a promise to provide a specified good or service to a customer, the entity will typically be deemed to be the principal.</td>
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<tr>
<td>Chapter 11</td>
<td>Customer Options for Additional Goods or Services (Material Rights)</td>
<td>Created a new chapter on accounting for customer options for additional goods or services (material rights) by relocating existing content from various chapters in the Roadmap. Refer to specific mapping of relocated content in the Relocated Content table below.</td>
</tr>
<tr>
<td>11.2.1</td>
<td>Need for Assessing Whether a Material Right Exists When the Residual Approach Was Used to Establish the Stand-Alone Selling Price of the Additional Goods or Services</td>
<td>Expanded the existing discussion on whether a material right exists when the residual approach was used to establish the stand-alone selling price of the additional goods and services. Specifically, we added factors for an entity to consider in determining whether a material right is present when the pricing of optional future purchases is highly variable or uncertain. Added Examples 11-1 and 11-2, which demonstrate the application of these concepts.</td>
</tr>
<tr>
<td>12.2</td>
<td>Scope of the Licensing Guidance</td>
<td>Added Connecting the Dots — Accounting for Licenses to Noncustomers.</td>
</tr>
<tr>
<td>12.2.1</td>
<td>Software in a Hosting Arrangement</td>
<td>Expanded discussion of the criteria in ASC 985-20-15-5, added practical considerations, and added Example 12-2.</td>
</tr>
<tr>
<td>12.3.6</td>
<td>Identifying Performance Obligations in a Hybrid Software Arrangement</td>
<td>Expanded discussion of hybrid software arrangements, which includes new Examples 12-12 and 12-13.</td>
</tr>
<tr>
<td>12.4.2</td>
<td>Symbolic IP</td>
<td>Added Connecting the Dots — Ongoing Activities, which highlights that ASC 606 does not require that the entity promise or expect to provide ongoing activities to maintain or support the IP for the license to be distinguished as symbolic IP. This is a difference between U.S. GAAP and IFRS Standards that is further discussed in Appendix A. Added discussion of period over which to recognize revenue for a perpetual license to symbolic IP.</td>
</tr>
<tr>
<td>Section</td>
<td>Title</td>
<td>Description</td>
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</tr>
<tr>
<td>12.7.6</td>
<td>Allocating Fixed Consideration and Sales- or Usage-Based Royalties in a Licensing Arrangement With More Than One Performance Obligation</td>
<td>Added Examples 12-33 and 12-34, which illustrate approaches that may be appropriate when a licensing arrangement includes (1) fixed consideration and sales- or usage-based royalties and (2) a license of functional IP as well as R&amp;D services.</td>
</tr>
<tr>
<td>13.3.3.4</td>
<td>Costs Incurred to Fulfill a Combined Performance Obligation Satisfied Over Time</td>
<td>Incorporated guidance from ASC 330 to help entities determine whether they may capitalize fulfillment costs related to part of a combined performance obligation that will be satisfied over time.</td>
</tr>
<tr>
<td>13.3.3.6</td>
<td>Labor Costs Incurred to Fulfill a Contract for Goods or Services When Revenue Is Recognized Over Time</td>
<td>Added this section to explain and provide examples of (1) the types of labor costs that may be incurred to fulfill a contract for goods or services when revenue is recognized over time and (2) when such costs might be capitalizable under the guidance.</td>
</tr>
<tr>
<td>15.2.3.3</td>
<td>Transaction Price Allocated to the Remaining Performance Obligations</td>
<td>Added content to discuss backlog disclosure considerations related to the SEC's final rule issued on August 26, 2020, that modernizes the disclosure requirements in SEC Regulation S-K, Items 101, 103, and 105.</td>
</tr>
<tr>
<td>16.1</td>
<td>Effective Date</td>
<td>Added content related to the issuance of ASU 2020-05, which permits private entities to defer adoption of ASC 606 under certain circumstances.</td>
</tr>
<tr>
<td>19.1</td>
<td>Background</td>
<td>Added the definition of the AFS income inclusion rule, a rule that is discussed throughout the chapter.</td>
</tr>
<tr>
<td>19.4</td>
<td>Step 2 — Identify the Performance Obligations</td>
<td>Added references to (1) IRC Section 451(c), as amended by the Tax Cuts and Jobs Act; (2) Proposed IRC Treasury Regulation Section 1.451-8; and (3) Rev. Proc. 2019-37, which provides procedural guidance for taxpayers on applying IRC Section 451(c) and Proposed IRC Treasury Regulation Section 1.451-8.</td>
</tr>
<tr>
<td>19.12</td>
<td>IRS Response to ASU 2014-19</td>
<td>Added references to Rev. Proc. 2018-60 and Rev. Proc. 2019-37, which were issued by the IRS in November 2018 and September 2019, respectively.</td>
</tr>
<tr>
<td>20.2.2.3</td>
<td>Requirement for Selected Financial Data</td>
<td>Added Changing Lanes on a proposed rule issued by the SEC on January 30, 2020, that would modernize and simplify MD&amp;A and certain financial disclosure requirements in SEC Regulation S-K.</td>
</tr>
</tbody>
</table>
### Appendix G — Changes Made in the 2020 Edition of This Publication

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<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>20.2.2.6</td>
<td>Pro Forma Financial Information Under Article 11</td>
<td>Added Changing Lanes on a final rule issued by the SEC on May 20, 2020, that amends the financial statement requirements for acquisitions and dispositions of businesses.</td>
</tr>
<tr>
<td>20.3.2</td>
<td>FASB Staff’s Revenue Recognition Implementation Q&amp;As</td>
<td>Added section on the FASB staff’s Implementation Q&amp;As, which were compiled from TRG Agenda Papers and other previously issued materials.</td>
</tr>
<tr>
<td>20.3.3.11</td>
<td>ASU 2019-08 on Share-Based Consideration Payable to a Customer</td>
<td>Added section to include a brief discussion of ASU 2019-08, which the FASB issued on November 11, 2019.</td>
</tr>
<tr>
<td>20.3.3.12</td>
<td>ASU 2020-05 on Deferral of the Effective Date for Certain Entities</td>
<td>Added section to include a brief discussion of ASU 2020-05, which the FASB issued on June 3, 2020.</td>
</tr>
</tbody>
</table>

### Appendix A — Differences Between U.S. GAAP and IFRS Standards

- **Share-based payments to customers** — Added a discussion noting that while ASU 2019-08 clarifies the accounting for share-based payments to customers under U.S. GAAP, IFRS Standards do not include similar guidance.
- **Licensing — hosting arrangements (see paragraph BC37 of ASU 2016-10)** — Added a discussion noting that while ASU 2016-10 contains explicit guidance to indicate that the license implementation guidance is not applicable to software subject to a hosting arrangement that does not contain a license under U.S. GAAP, IFRS Standards do not include similar explicit guidance.
- **Onerous contracts** — Added a discussion noting that while losses are recognized for all onerous contracts with customers under IAS 37, recognition of losses is required for only certain types of contracts with customers under U.S. GAAP.
### Amended or Deleted Content

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
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<tbody>
<tr>
<td>5.2.2.2</td>
<td>Accounting for Virtual Goods</td>
<td>Expanded the existing discussion on accounting for virtual goods by developers of online games to include factors for an entity to consider when assessing the nature of the implied promise associated with hosting an online game.</td>
</tr>
<tr>
<td>5.3.2.3.3</td>
<td>Identifying Performance Obligations in a Cloud Computing Arrangement That Includes Implementation Services</td>
<td>Expanded the existing discussion on whether implementation services in a cloud computing arrangement are a promised good or service and, if so, whether they are a distinct performance obligation. Added factors that may be helpful in an entity's determination of whether implementation services are a distinct performance obligation.</td>
</tr>
<tr>
<td>5.3.3.1.1</td>
<td>Specified Quantity of Distinct Goods or Services</td>
<td>Amended the content of what is now Example 5-5 to refer to monthly cleaning services instead of monthly payroll processing services.</td>
</tr>
<tr>
<td>6.6</td>
<td>Consideration Payable to a Customer</td>
<td>Amended the content of what is now Changing Lanes — ASU 2018-07 on Nonemployee Share-Based Payment Accounting and ASU 2019-08 on Share-Based Consideration Payable to a Customer to include a discussion of ASU 2019-08, which requires entities to (1) measure and classify share-based sales incentives by applying the guidance in ASC 718 and (2) reflect the resulting measurement as a reduction of revenue in accordance with the guidance in ASC 606 on consideration payable to a customer.</td>
</tr>
<tr>
<td>8.4.5.1</td>
<td>Alternative Use</td>
<td>Clarified that an entity's assessment of alternative use should be performed at contract inception and should not be updated unless there is a contract modification that substantively changes the performance obligation.</td>
</tr>
<tr>
<td>8.4.5.2</td>
<td>Enforceable Right to Payment for Performance Completed to Date</td>
<td>Clarified that payment terms by themselves do not support a determination of whether an entity has an enforceable right to payment for performance completed to date. Rather, the entity should evaluate whether it has an enforceable right to payment if the contract were to be terminated for reasons other than the entity's failure to perform.</td>
</tr>
<tr>
<td>8.5.9.3</td>
<td>Incremental Costs of Obtaining a Contract</td>
<td>Clarified that costs of fulfilling a contract that depict an entity's performance would be included in the measurement of progress.</td>
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</tbody>
</table>
### Appendix G — Changes Made in the 2020 Edition of This Publication

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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<tbody>
<tr>
<td>8.6.7</td>
<td>Customer Acceptance</td>
<td>Updated flowchart to clarify that when customer acceptance is based on a subjective evaluation, either revenue should not be recognized until acceptance occurs or the customer acceptance should be treated as a right of return, depending on the facts and circumstances.</td>
</tr>
<tr>
<td>8.9.2</td>
<td>Partially Satisfied Performance Obligations Before the Identification of a Contract</td>
<td>Clarified that an entity would generally not record a receivable (or a related contract liability) to reflect its right to payment for performance completed before meeting the step 1 criteria.</td>
</tr>
<tr>
<td>9.2.2.2</td>
<td>Blend-and-Extend Contract Modifications</td>
<td>Amended the discussion on blend-and-extend (B&amp;E) contract modifications to include our view that it is also acceptable for an entity to conclude that a B&amp;E contract modification is always a termination of an existing contract and the creation of a new contract (i.e., an entity is not required to perform an analysis of the stand-alone selling price of the additional goods or services).</td>
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<tr>
<td>13.2.2.1</td>
<td>Tiered Commission</td>
<td>For Examples 13-2 through 13-5, expanded explanation of pro-rata capitalization of commission costs under Approach B.</td>
</tr>
<tr>
<td>13.4.1.1</td>
<td>Allocation Among Performance Obligations</td>
<td>Amended the section by incorporating the FASB staff's views expressed in Implementation Q&amp;A 75 on how to allocate capitalized incremental costs of obtaining a contract among different performance obligations.</td>
</tr>
<tr>
<td>16.1.1</td>
<td>Effective Date for Emerging Growth Companies</td>
<td>Amended content to reflect the guidance in ASU 2020-05, which permits private entities to defer adoption of ASC 606 under certain circumstances.</td>
</tr>
<tr>
<td>19.2</td>
<td>General U.S. Federal Income Tax Principles for Revenue Recognition</td>
<td>In this section and subsequent sections of Chapter 19, replaced references to the no later than book rule and the book conformity rule with references to the AFS income inclusion rule.</td>
</tr>
<tr>
<td>19.4</td>
<td>Step 2 — Identify the Performance Obligations</td>
<td>Removed tax implication of changes in classification of an item from an asset to a liability.</td>
</tr>
<tr>
<td>20.2.2.10</td>
<td>Transition Considerations for EGCs</td>
<td>Removed Example 19-4, “Registrant No Longer Qualifies as an EGC During the PBE Year of Adoption,” because the PBE year of adoption has lapsed.</td>
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## Relocated Content (Excluding Mapping of 2019 Roadmap Q&As)

<table>
<thead>
<tr>
<th>2019 Section</th>
<th>Title</th>
<th>2020 Section</th>
<th>Title</th>
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<tr>
<td>5.6</td>
<td>Customer Options for Additional Goods or Services (Material Rights)</td>
<td>Chapter 11</td>
<td>Customer Options for Additional Goods or Services (Material Rights)</td>
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<td>17.6.2</td>
<td>Identifying the Contract</td>
<td>4.3.5.5</td>
<td>Assessing Collectibility in Real Estate Sales</td>
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<tr>
<td>17.6.3</td>
<td>Identifying the Performance Obligations</td>
<td>5.3.4</td>
<td>Identifying Performance Obligations in Real Estate Sales</td>
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<tr>
<td>17.6.4</td>
<td>Determining the Transaction Price and Allocating It to the Performance Obligations</td>
<td>6.3.5.5.2</td>
<td>Variable Consideration in Real Estate Sales</td>
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</table>

## Mapping of 2019 Roadmap Q&As to 2020 Roadmap Sections

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<th>2019 Q&amp;A</th>
<th>Title</th>
<th>2020 Section</th>
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<td>3-1</td>
<td>Sequence of Revenue Steps and Whether All Five Must Be Performed</td>
<td>3.1.2</td>
<td>Applying the New Standard</td>
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<td>3-2</td>
<td>Deciding Whether a Portfolio Approach May Be Used</td>
<td>3.1.2.2.1</td>
<td>Deciding Whether a Portfolio Approach May Be Used</td>
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<td>3-3</td>
<td>Application of a Portfolio Approach to Part of a Customer Base</td>
<td>3.1.2.2.2</td>
<td>Applying the Portfolio Approach to Some, but Not Other, Similar Contracts</td>
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<td>Performance Guarantees</td>
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<td>Profit Margin Guarantees</td>
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<td>Profit Margin Guarantees</td>
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<td>Whether Contributions Are Within the Scope of ASC 606</td>
<td>3.2.3</td>
<td>Contributions</td>
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<td>3-7</td>
<td>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</td>
<td>3.2.4</td>
<td>Nonmonetary Transaction Between Entities in the Same Line of Business</td>
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<td>Whether Barter Credit Transactions Are Within the Scope of ASC 606</td>
<td>3.2.5</td>
<td>Barter Credit Transactions</td>
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<td>Lapsed Unexercised Warrants</td>
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<td>Accounting for Incentive-Based Capital Allocation Arrangements</td>
<td>3.2.11.2</td>
<td>Incentive-Based Capital Allocation Arrangements</td>
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<td>Scope of ASC 606: Bank-Issued Credit Card Arrangements</td>
<td>3.2.11.3.4</td>
<td>Arrangements Involving Bank-Issued Credit Cards</td>
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<td>Presentation of Physically Settled Commodity Contracts That Are Derivatives</td>
<td>3.2.11.4</td>
<td>Physically Settled Commodity Contracts That Are Derivatives</td>
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<td>Accounting for Proceeds From the Sale of Scrap Materials or By-Products</td>
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<td>Accounting for Proceeds From the Sale of Scrap Materials or By-Products</td>
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<td>Written Sales Agreement Being Prepared but Not Yet Signed</td>
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<td>Identifying a Contract With a Customer</td>
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<td>Title</td>
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<td>4-2</td>
<td>Comparison of Requirements Under ASC 606 and ASC 605 for a Contract’s Existence</td>
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<td>Criteria for Identifying a Contract With a Customer</td>
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<td>Contract Extensions</td>
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<td>Each Party Has Approved the Contract and Is Committed to Perform</td>
</tr>
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<td>Price Concession Indicators</td>
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<td>4-6</td>
<td>Assessing Collectibility for a Portfolio of Similar Contracts</td>
<td>4.3.5.4</td>
<td>Whether to Assess Collectibility at the Portfolio Level or the Individual Contract Level</td>
</tr>
<tr>
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<td>Determining Whether a License Arrangement Includes a Substantive Termination Penalty</td>
<td>4.4.1.1</td>
<td>Termination Clauses in License Arrangements</td>
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<td>4-8</td>
<td>Reassessment of Collectibility</td>
<td>4.5</td>
<td>Reassessing the Criteria for Identifying a Contract</td>
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<tr>
<td>4-9</td>
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