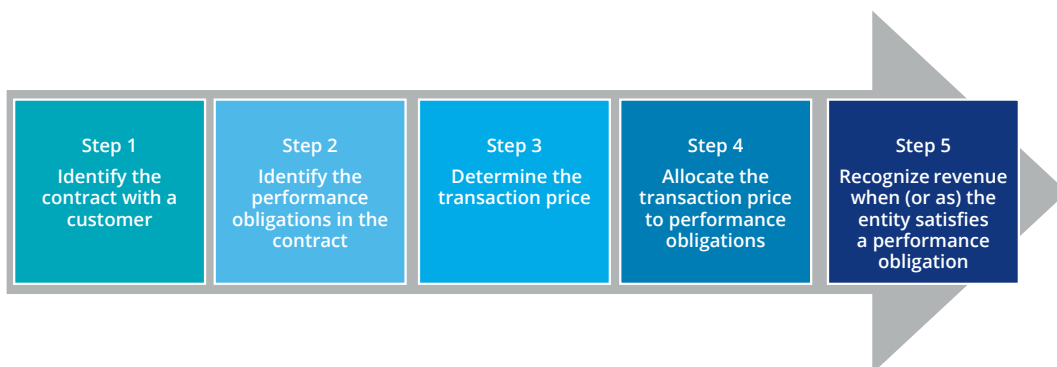




## On the Radar Revenue Recognition

The core principle of the revenue standard is to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods and services. Significant judgments frequently need to be made when an entity evaluates the appropriate recognition of revenue from contracts with customers. These judgments are often required throughout the revenue standard's five-step process that an entity applies to determine when, and how much, revenue should be recognized.



Application of the five steps illustrated above requires a critical assessment of the specific facts and circumstances of an entity's arrangement with its customer. Some of the more challenging and judgmental aspects of applying the revenue standard are highlighted below.

**Entities often have difficulty determining the appropriate judgments to apply in the identification of performance obligations and the assessment of whether an entity is a principal or an agent, as described below. Not surprisingly, these are two topics of the revenue standard on which entities commonly seek the SEC staff's views in pre-filing submissions. In addition, these topics are frequently discussed in SEC staff speeches at the annual AICPA & CIMA Conference on Current SEC and PCAOB Developments.**

### Identifying Performance Obligations

A performance obligation is the unit of account for which revenue is recognized, and the identification of performance obligations affects the revenue recognition timing. A performance obligation is a promise that an entity makes to transfer to its customer a "distinct" good or service. Contracts with customers often include multiple promises, and it can be difficult for an entity to (1) identify the activities it is undertaking that qualify as promises to provide goods or services and (2) determine which promises are distinct. An entity should answer two questions to evaluate whether a promised good or service is distinct and, thus, a separate performance obligation:

- Can the customer benefit from the good or service on its own or with other readily available resources (i.e., is the good or service capable of being distinct)?
- Is the entity's promise to transfer the good or service separately identifiable from other promises in the contract (i.e., is the good or service distinct within the context of the contract)?

Only when the answer to each question above is yes for a promised good or service (or bundle of goods or services) is the promised good or service (or bundle of goods or services) distinct and, therefore, a performance obligation. If the two revenue recognition criteria for identifying a distinct good or service are not met, an entity must combine goods or services until it identifies a bundle that is distinct.

Answering the first question can be straightforward but is not always so. If an entity typically sells a good or service on its own, or if the good or service can be used with another good or service that the entity (or another vendor) sells separately, the answer to the first question is likely to be yes. The key is whether a customer can generate some economic benefits from the good or service on its own or with other readily available resources.

Answering the second question is often more challenging. For an entity to assess whether its promise to transfer a good or service is separately identifiable from other goods or services in a contract, the entity should evaluate 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.

<b>The revenue standard includes indicators of when two or more promised goods or services are not separately identifiable, including situations in which:</b>	<ol style="list-style-type: none"><li>1. An entity provides a significant service of integrating goods and services into a combined output or outputs (e.g., constructing a building).</li><li>2. One or more goods or services significantly modify or customize one or more other goods or services (e.g., customizing specialized equipment).</li><li>3. The goods and services are highly interdependent or interrelated in such a way that they significantly affect one another (e.g., providing software with critical updates).</li></ol>
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Broadly speaking, if multiple promised goods or services represent inputs to a combined output, the combined output would typically be greater than (or substantively different from) the sum of those inputs.

## Assessing Whether an Entity Is a Principal or an Agent

It is not uncommon for more than one party to be involved in providing goods or services to a customer. Whenever another party is involved, an entity must evaluate whether its promise is to provide the goods or services itself as a principal or to arrange for another party to provide the goods or services to a customer. Such a determination significantly affects the amount of revenue an entity records. This is because a principal records as revenue the gross amount of consideration from the customer (with a corresponding cost for the amount paid to the other party involved in providing goods or services to the customer) while an agent records the net amount retained from the transaction.

The unit of account for performing the principal-versus-agent assessment is called the “specified” good or service, which is the good or service that an entity determines to be distinct by using the same criteria that apply to the identification of performance obligations. The underlying principle in determining whether an entity is a principal or an agent is to evaluate whether the entity controls the specified good or service (i.e., an asset) before transferring it to the customer. ASC 606-10-25-25 states, in part, that “[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.” Determining whether the entity controls the specified good or service before transferring it to the customer — and, therefore, is the principal in the arrangement — may be clear in some circumstances but may require significant judgment in others.

**There are three key indicators to help the entity make this assessment:**

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
- The entity has inventory risk before the specified good or service has been transferred to the customer or after transfer of control to the customer (e.g., if the customer has a right of return).
- The entity has discretion in establishing the price for the specified good or service. However, an agent can have discretion in establishing prices in some cases.

These indicators are intended to support a conclusion that the entity does or does not control the specified good or service before transferring it to the customer and should not be used as a checklist that overrides the underlying principle of control.

The framework for evaluating whether an entity is a principal or an agent is also relevant to the determination of the party to which control of a specified good or service is transferred (i.e., which party is the entity's customer). This evaluation is particularly relevant when an intermediary (e.g., a distributor or reseller) is involved in reselling the entity's goods or services to an end customer. If an entity determines that control of a specified good or service is transferred to an intermediary, the intermediary is the entity's customer, and the entity records revenue based on the amount that it expects the intermediary to pay. However, if the entity concludes that the intermediary does not obtain control of the specified good or service before the good or service is transferred to the end customer, the amount of revenue that the entity records is based on the consideration (if known) that the entity expects the end customer to pay.

## Variable Consideration

Many revenue contracts include variable consideration, including price concessions, rebates, incentives, royalties, and performance-based bonuses or penalties. Generally, the revenue standard requires an entity to estimate variable consideration, with recognition subject to a constraint such that it is probable that a significant reversal of cumulative revenue recognized will not occur. There are a few exceptions to the requirement to estimate variable consideration, including sales- or usage-based royalties associated with a license of intellectual property (IP) that is the predominant item. In addition, entities must carefully evaluate whether variable consideration should be allocated to one or more, but not all, performance obligations in a contract (or one or more, but not all, distinct goods or services that are part of a series of distinct goods or services that represent a single performance obligation). For example, some usage-based fees may be allocated to a distinct day of service that is part of a series of services.

## Consideration Payable to a Customer

From time to time, an entity may provide a cash payment or incentive to a customer, a customer's customer, or another party in the distribution chain. An entity must carefully evaluate whether a payment or incentive provided to a customer's customer should be accounted for in accordance with the guidance in ASC 606 on consideration payable to a customer. For example, when an entity arranges for goods or services to be provided by a vendor to a consumer, it may be difficult for the entity to determine whether it should apply the guidance on consideration payable to a customer to a payment or incentive provided to the consumer (i.e., the end customer) since both the vendor and the consumer could be viewed as customers of the entity.

Further, an entity should consider whether a payment or incentive provided to a customer or a customer's customer is in exchange for a good or service that is distinct from the goods or services provided to the customer.

## Licensing

The revenue standard includes specific guidance on the licensing of an entity's IP. For example, revenue associated with the license of functional IP (e.g., software, film, music, drug compound/formula) is typically recognized at a point in time (unless combined as a single performance obligation with a service that is recognized over time) while revenue associated with a license of symbolic IP (e.g., franchise, trade or brand name, logo) is typically recognized over time. Accordingly, entities may need to apply different revenue recognition methods for different types of licenses. However, the general framework used to account for licensing of IP is essentially the same as the framework used to account for the sale of other goods or services (i.e., the five-step model described above). As noted above, one exception to the general framework is the accounting for sales- or usage-based royalties associated with licensing of IP that is the predominant item.

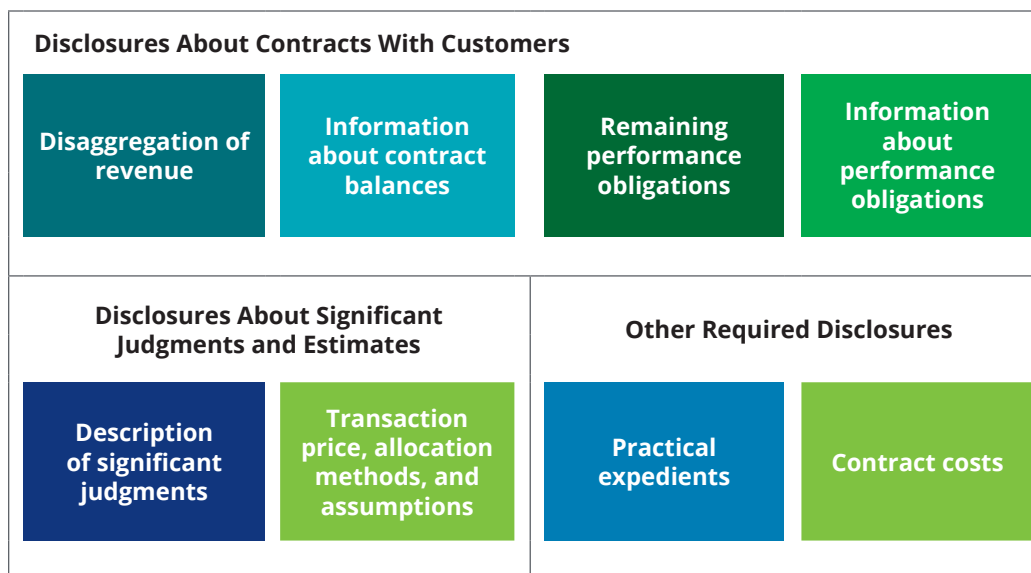
Licensing of IP can take many forms, and the economics and substance of such transactions can often be difficult to identify. This is because (1) a license is defined by the contractual rights conveyed to a customer and (2) the accounting for such rights is highly dependent on how those rights are defined and what, if any, additional promised goods or services are required to be provided along with such rights. Therefore, an entity may find that no two contracts are the same and that new judgments must be made with each arrangement. As more and more entities expand their product offerings to include technology-related products or services, assessing the appropriate revenue recognition for licensing of IP continues to be a topic of focus for many entities.

## Financial Statement Disclosures

The 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 illustration below gives an overview of the annual revenue disclosure requirements for public entities. Nonpublic entities can elect not to provide certain disclosures, and the disclosure requirements for interim periods are significantly reduced in scope from the illustration below.

## Annual Disclosures



## SEC Comment Letters

Revenue remains a hot topic of SEC comment letters. Key themes of SEC comment letters related to revenue recognition include the following:

Theme	Example(s)
Significant judgments	<ul style="list-style-type: none"> <li>• Identification of performance obligations.</li> <li>• Principal-versus-agent assessment.</li> <li>• Determination of the transaction price.</li> <li>• Allocation of the transaction price.</li> <li>• Identification of a measure of progress.</li> </ul>
Disclosures of performance obligations	<ul style="list-style-type: none"> <li>• Timing of revenue recognition.</li> <li>• Significant payment terms.</li> <li>• Significant financing components.</li> <li>• Nature of goods and services (e.g., principal-versus-agent considerations).</li> </ul>
Contract costs	<ul style="list-style-type: none"> <li>• Method being used to amortize the capitalized costs.</li> <li>• How the selected amortization period correlates with the period of benefit.</li> <li>• Whether commissions paid upon renewal are commensurate with the initial commissions.</li> <li>• How renewals are considered in the amortization period.</li> </ul>
Disclosures of disaggregation of revenue	<ul style="list-style-type: none"> <li>• Consideration of information disclosed outside of the financial statements (e.g., earnings calls, investor presentations).</li> <li>• An entity's business model.</li> <li>• Whether the categories disclosed depict how revenue and cash flows are affected by economic factors.</li> </ul>
Disclosures of contract balances	How contract balances are derived.
Disclosures of remaining performance obligations	When an entity expects to recognize revenue.

The SEC also continues to focus on non-GAAP metrics, including adjustments that change the accounting policy or the method of recognition of an accounting measure that may be misleading and, therefore, impermissible. For example, a non-GAAP performance measure that reflects revenue recognized over the service period under GAAP on an accelerated basis as if the registrant earned revenue when it billed its customers is likely to be prohibited because it is an individually tailored accounting principle and does not reflect the registrant's required GAAP recognition method. However, in certain circumstances, the SEC may not object when a registrant presents the amount of revenue billed to a customer — that is, “billings” or “bookings” (with appropriate characterization) as an operational metric — because such measures are not considered non-GAAP measures. For more information, see Deloitte's Roadmap [Non-GAAP Financial Measures and Metrics](#).

## Accounting Standards Update on Revenue Contracts Acquired in Business Combinations

In October 2021, the FASB issued [ASU 2021-08](#), which amends the guidance in ASC 805 to address the recognition and measurement of revenue contracts with customers acquired in a business combination. The ASU requires an entity to apply the revenue standard when recognizing and measuring contract assets and contract liabilities arising from those contracts. By contrast, fair value is the measurement model that is applied to most assets and liabilities (e.g., customer relationship intangibles) acquired in a business combination.

### Postimplementation Review

After the FASB issues a major new accounting standard, it performs a postimplementation review (PIR) process to evaluate whether the standard is achieving its objective by providing users of financial statements with relevant information that justifies the costs of providing it. This process enables the Board to solicit and consider stakeholder input and FASB staff research. At its [July 28, 2021](#), and [September 21, 2022](#), meetings, the FASB discussed feedback received to date on the revenue standard as well as the results of research performed on certain revenue topics, including disclosures, short-cycle manufacturing, principal-versus-agent considerations, licensing, and variable consideration. In the handouts prepared for the Board's [July 2021](#) and [September 2022](#) meetings, the FASB staff noted that stakeholder feedback on the revenue standard was positive overall, particularly from users of financial statements since the standard results in more useful and transparent information, improved disclosures, and comparability across entities and industries. The staff further observed that while many preparers noted significant one-time costs associated with implementation of the standard, they also highlighted that the standard has been beneficial in the long run.

On November 10, 2023, the FASB hosted a [public roundtable](#) on the PIR of ASC 606. During this meeting, participants discussed the benefits and costs of the revenue standard, implementation challenges, improvements to the standard-setting process, and assessment of the PIR process.

The PIR of ASC 606 was further discussed at the FASB's May 8, 2024, meeting, whose agenda was facilitated by a [handout](#) prepared by the FASB staff in advance. At the meeting, the FASB staff updated Board members and other participants on feedback received from stakeholders about benefits, costs, and implementation challenges associated with the adoption of the revenue standard. In addition to giving an overview of topics discussed at prior meetings, the staff observed that stakeholders appreciated the revenue standard's (1) elimination of industry-specific guidance, (2) provision of comprehensive principles-based guidance, and (3) convergence with IFRS® Accounting Standards. However, the staff acknowledged stakeholders' observation that in addition to the one-time implementation costs, application of the revenue standard has resulted in higher ongoing costs, primarily because ASC 606 requires entities to exercise greater judgment than they did when applying legacy revenue guidance. Also at the meeting, Board members discussed the revenue standard's impacts on comparability, including challenges faced by specific industries upon the elimination of industry specific guidance. The staff observed that stakeholders generally agreed that the benefits of eliminating this guidance have outweighed the costs of doing so. In addition, the following implementation challenges were discussed:

- Licensing.
- Identification of performance obligations.

- Stand-alone selling price.
- Constraint on variable consideration.
- Sales-based or usage-based royalties.
- Principal-versus-agent considerations.
- Consideration payable to a customer.
- Incremental costs of obtaining a contract.
- Short-cycle manufacturing.
- Disclosures.
- Accounting for loss contracts (also referred to as onerous contracts).
- The interaction between ASC 606 and ASC 815 in the accounting by a seller (grantee) for warrants granted by a customer when those warrants vest upon the seller's satisfaction of the performance obligation.

At the FASB's October 2, 2024, [meeting](#), the Board resumed its discussion of the PIR but made no additional tentative decisions related to it. As indicated in the FASB staff's [handout](#) for the meeting, the staff is drafting a PIR report that will be posted on the FASB's [Web site](#) pending input from the Board members and final approval from the board of trustees of the Financial Accounting Foundation, the FASB's parent organization.

## Other Ongoing FASB Projects

The FASB continues to develop accounting standards with revenue implications. Recent standard-setting developments as of October 15, 2024, include those related to the following topics:

- *Derivative scope refinements and share-based consideration received from a customer* — On July 23, 2024, the FASB issued a [proposed ASU](#) that would (1) refine the scope of the guidance on derivatives in ASC 815 and (2) clarify the scope of the guidance on share-based payments from a customer in ASC 606. The proposed ASU is intended to address concerns about the application of derivative accounting to contracts that have features based on the operations or activities of one of the parties to the contract and to reduce diversity in the accounting for share-based payments in revenue contracts. For more information, see Deloitte's August 2, 2024, [Heads Up](#).
- *Share-based consideration payable to a customer* — On September 30, 2024, the FASB issued a [proposed ASU](#) that would clarify the guidance in both ASC 606 and ASC 718 on the accounting for share-based payment awards that are granted by an entity as consideration payable to its customer. The proposed ASU's purpose is to reduce diversity in practice and improve existing guidance, primarily by revising the definition of a "performance condition" and eliminating a forfeiture policy election specifically for service conditions associated with share-based consideration payable to a customer. In addition, the proposed ASU would clarify that the variable consideration constraint guidance in ASC 606 does not apply to share-based consideration payable to a customer regardless of whether an award's grant date has occurred. For more information, see Deloitte's October 1, 2024, [Heads Up](#).
- *Accounting for government grants* — On November 1, 2023, the FASB added to its technical agenda a [project](#) on the recognition, measurement, and presentation of government grants received by business entities. The Board's tentative decisions related to the project include the following:
  - A government grant should be recognized when it is probable that the entity will comply with the conditions of the grant and the grant will be received.
  - The accounting framework of IAS 20 for government should be leveraged. However, targeted improvements to the guidance, including refinements to its scope and the recognition threshold, should be made.

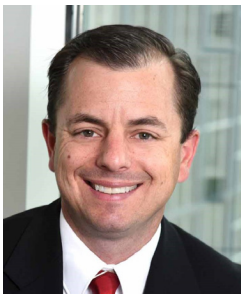
- The disclosure requirements of ASC 832 should apply to government grants within the scope of the project.
- Specific guidance should be provided on whether and, if so, how to recognize and measure grant-related liabilities in a business combination

The Board is expected to include its tentative decisions in a forthcoming proposed ASU.

Stakeholders should monitor the FASB's [Web site](#) for further developments.

See Deloitte's Roadmap [Revenue Recognition](#) for a more comprehensive discussion of accounting and financial reporting considerations related to the recognition of revenue from contracts with customers under ASC 606.

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