



## 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 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 before transferring it to the customer. Control is defined as “the ability to direct the use of, and obtain substantially all of the remaining benefits from, an 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. Many entities have had to implement significant changes to their internal controls to develop processes for estimating and constraining variable consideration. 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.

**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.

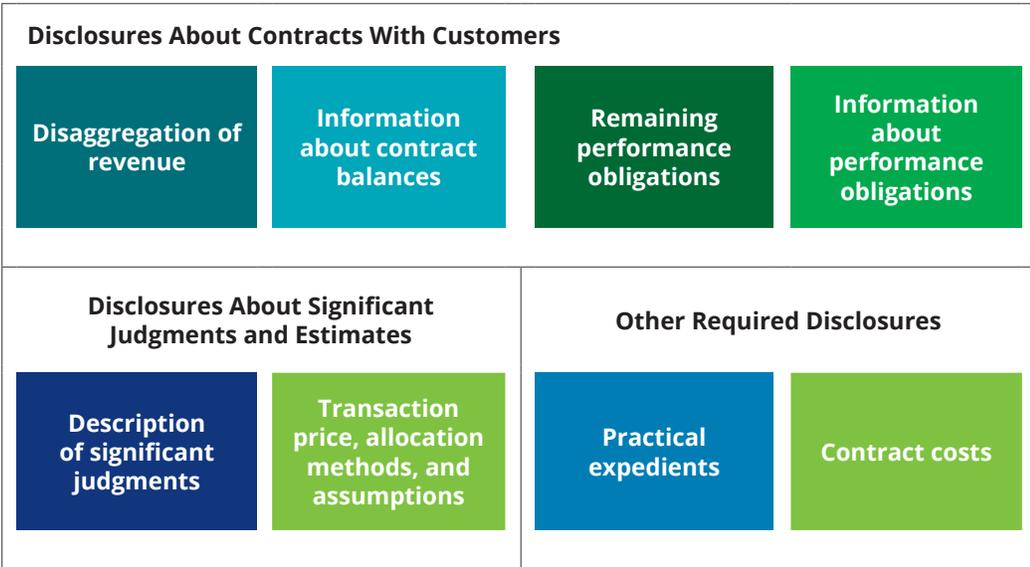
Licensing of IP can take many forms, and the economics and substance of such transactions can often be difficult to identify. This is because (1) a license is defined by the contractual rights conveyed to a customer and (2) the accounting for such rights is highly dependent on how those rights are defined 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 disclosure requirements under the revenue standard are significant and more comprehensive than those under legacy revenue guidance. Entities are required 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.

## On the Horizon

After the FASB issues a major new accounting standard, it begins 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, meeting, the FASB discussed feedback received to date on the revenue standard. In a [handout](#) prepared for the meeting, 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. As the PIR process for the revenue standard continues, the Board and its staff may identify areas of improvement that could result in future standard setting.



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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