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A guide to revenue recognition

May 2024

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1. Executive summary

1.1 Introduction

1.1.1 Background and status

In 2014, the FASB and IASB issued substantially converged final standards on revenue recognition. These final standards were the culmination of a joint project between the Boards that spanned many years. The FASB's ASU 2014-09 provides a robust framework for addressing revenue recognition issues and replaced almost all pre-existing revenue recognition guidance in U.S. GAAP (i.e., legacy GAAP), including industry-specific guidance and SAB Topic 13 (which was also part of legacy GAAP for public entities). The guidance added to the ASC by ASU 2014-09 primarily includes ASC 606, ASC 340-40 and ASC 610-20.

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint TRG, which has discussed many implementation issues. In addition, the AICPA organized several industry-specific task forces to identify and provide guidance on industry-specific implementation issues in a comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG). Based on the TRG's and AICPA industry-specific task forces' activities and other sources of feedback, the FASB has made several revisions to the new guidance since its issuance. The FASB's Revenue Recognition Implementation Q&As (FASB RRI Q&As) highlight the revisions made to the new guidance. The FASB RRI Q&As do not include the full discussion and analysis from the TRG papers. Therefore, references to certain TRG papers have been retained throughout the guide. For ease of use, definitions for acronyms and titles for ASC topics and subtopics and other accounting literature referred to in this executive summary are included in Appendix B.

1.1.2 Significant changes

While the policies used by almost all entities to account for revenue and certain related costs were affected by the new guidance, the degree of change to a specific entity's revenue recognition policies and the effects the changes have on the entity's financial statements varied depending on the nature and terms of the entity's revenue-generating transactions. In addition, entities in some industries (e.g., technology) were affected by the new guidance more than entities in other industries (e.g., traditional retail). It is important to note, however, that entities in virtually all industries were significantly affected by the disclosure requirements in the new guidance. For additional information about how certain industries were affected by the new guidance, refer to our Industry revenue recognition white papers.

Examples of significant changes incorporated into the new guidance that could affect how an entity accounts for its contracts with customers include the following:

- *Transfer of control model*. Focus on the transfer of control, instead of the transfer of risks and rewards of ownership (which is used pervasively in legacy GAAP), for purposes of determining when to recognize revenue
- *Variable consideration*. Use of a model that may result in estimates of variable consideration being included in the transaction price (and recognized as revenue) sooner than they would be under legacy GAAP
- *Significant financing component*. Incorporation of a significant financing component (caused by either advance payment or deferred payment terms with the customer) into the measurement of revenue (with certain exceptions), which is only done under legacy GAAP in the context of accounting for long-term receivables
- *Licenses*. Use of one comprehensive approach to account for all licenses and rights to use IP instead of the limited-scope industry-specific models in legacy GAAP

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- *Multiple-element arrangements*. Use of one comprehensive approach to account for multiple-element arrangements instead of the general model (i.e., ASC 605-25) and industry-specific models in legacy GAAP
- *Contract costs*. Requirement to capitalize certain costs related to a contract with the customer (e.g., sales commissions, setup costs) under certain circumstances instead of having the option to do so in certain cases under legacy GAAP

In addition, the disclosure requirements in the new guidance will cause the volume of revenue-related information disclosed in the financial statements to significantly increase, particularly for public entities.

1.2 Scope

1.2.1 Overall scope

ASC 606 addresses revenue from contracts with customers. As such, key to understanding what is within the scope of ASC 606 are the definitions of revenue and customer:

- Revenue (Master Glossary of the ASC): "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."
- Customer (ASC 606-10-15-3): "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."

While the scope of ASC 606 is limited to revenue from contracts with customers, many aspects of the guidance in ASC 606 also are applicable to transfers of nonfinancial assets and in substance nonfinancial assets to counterparties other than customers within the scope of ASC 610-20.

All contracts with customers fall within the scope of ASC 606, except those for which other guidance is provided in the ASC (e.g., leases, insurance contracts, financial instruments, guarantees, nonmonetary exchanges). There are no other scope exceptions in ASC 606 for certain industries that have had their own contract-based revenue recognition guidance in legacy GAAP. Examples of industries that are subject to ASC 606 and that no longer have their own separate industry-specific revenue recognition guidance include the construction, real estate, software and franchising industries.

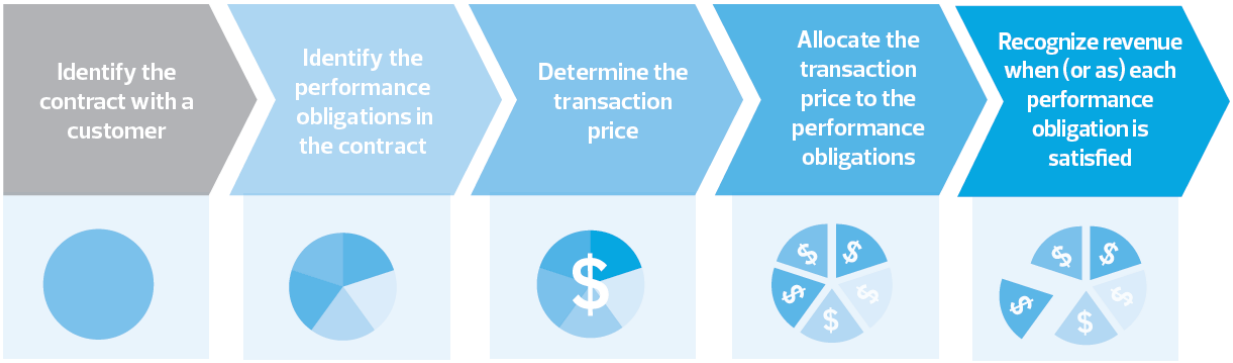
1.2.2 Contracts only partially within the scope of ASC 606

A contract may be partially within the scope of ASC 606 and partially within the scope of other guidance in the ASC (e.g., a contract that includes a guarantee [other than a product or service warranty] within the scope of ASC 460 and other goods or services within the scope of ASC 606). In this situation, the entity is required to separate and measure the component of a contract within the scope of the other guidance in accordance with that guidance. If the other guidance does not state how to separate and (or) measure the component of the contract within its scope (i.e., the non-ASC 606 component) and the component of the contract within the scope of ASC 606 (i.e., the ASC 606 component), the separation and (or) measurement guidance in ASC 606 is applied as needed. The amount allocated to the non-ASC 606 component of a contract is recognized using the other applicable guidance, and the amount allocated to the ASC 606 component is recognized in accordance with ASC 606.

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1.3 Core principle and key steps

The core principle underlying the guidance in ASC 606, which is included in ASC 606-10-10-2, 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." ASC 606-10-05-4 sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



An entity should consistently apply the guidance in ASC 606 to similar contracts and in similar situations.

1.4 Step 1: Identify the contract with a customer

1.4.1 Definition of a contract

Because ASC 606 provides guidance on how an entity should account for contracts with its customers, it is important to determine whether a contract exists. A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." An entity's enforceable rights and obligations in a revenue-generating transaction typically include its obligation to transfer specific goods or services to the customer and its right to receive payment for the specific goods or services transferred.

If both parties to an agreement that otherwise meets the definition of a contract have the unilateral and enforceable right to terminate the agreement without having to compensate the other party when the agreement is wholly unperformed by both parties, a contract does not exist for accounting purposes.

1.4.2 Contract existence criteria

The existence of a contract is not enough in and of itself to require application of the remaining steps in the ASC 606 revenue recognition model to the contract. Only if a contract meets the following contract existence criteria should it be accounted for in accordance with that model:

- Approvals have been obtained and a commitment to perform exists on the part of both parties.
- Rights of both parties are identifiable.
- Payment terms are identifiable.
- Commercial substance exists.
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur).

These criteria are first evaluated at contract inception and, if all of the criteria are met, they only need to be reassessed if there is a significant change in circumstances. While any reassessment should not result

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in the reversal of any revenue already recognized, an entity should consider whether any receivables or contract assets recognized before the significant change in circumstances are impaired.

In situations in which one or more of the contract existence criteria is not met at contract inception, the entity should reassess the criteria each reporting period (as necessary) to determine whether all of the criteria subsequently are met. At the point in time that all of the criteria are met, the remaining steps in the revenue recognition model in ASC 606 are applied. Until that point in time, the entity recognizes a liability for any consideration received. While the contract existence criteria are not met, the entity only derecognizes that liability and recognizes revenue when the amounts paid by the customer are nonrefundable and one of the following is true:

- The entity has no remaining performance obligations and it has received all, or substantially all, of the amounts promised by the customer.
- The contract has been terminated.
- The entity has: (a) transferred control of the goods or services to which the nonrefundable consideration relates and (b) stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services.

These are the only three circumstances under which revenue is recognized when the contract existence criteria are not met.

1.4.3 Combining contracts

While ASC 606 generally applies to individual contracts, criteria are provided to assess whether individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time should be combined for accounting purposes. When a contract is referred to in this executive summary, it could mean a standalone contract or two or more contracts combined based on meeting these criteria.

1.4.4 Portfolio of contracts

ASC 606 may be applied to a portfolio of similar contracts if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts. If an entity elects this practical expedient, any estimates or judgments it makes in applying ASC 606 to the portfolio of contracts should reflect the portfolio's size and composition.

1.4.5 Contract modifications

Contract modifications occur when the entity and its customer agree to add or change enforceable rights and obligations in the contract (e.g., changes to the contract's scope and [or] price). In general, contract modifications must be properly approved by both parties before the entity accounts for the modification. However, if a contract modification includes changes to both the scope and price of the contract, and the scope changes have been properly approved, but the price changes have not yet been properly approved, the entity applies the variable consideration guidance in ASC 606 to determine the transaction price for the modified contract and accounts for the modification using the appropriate model.

The accounting model applied to a contract modification under ASC 606 depends on several factors, including the pricing of the modification, whether any new products or services added by the modification are distinct and whether any of the remaining goods or services are part of a partially satisfied single performance obligation. Depending on the facts and circumstances, a contract modification could be accounted for as: (a) a separate contract, (b) the termination of one contract and execution of a new contract (which results in prospective treatment) or (c) part of the original contract (which could result in the recognition of a cumulative catch-up adjustment).

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1.5 Step 2: Identify the performance obligations in the contract

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. The first step in identifying the performance obligations in the contract is to identify all of the promises to provide goods or services in the contract. Once that step is complete, criteria are applied to determine whether the promises to provide goods or services should be treated as performance obligations and accounted for separately.

1.5.1 Identifying promises to transfer goods or services

Promises to transfer goods or services come in a variety of shapes and sizes—goods, services, rights to goods or services, licenses of IP, stand-ready obligations, when-and-if-available upgrade rights and options to purchase additional goods or services, just to name a few. While promised goods and services are most often explicitly stated in the contract, consideration also needs to be given to whether there are promises to transfer goods or services that arise out of an entity's customary business practices instead of an explicit contract provision. If an entity's customary business practice, published policy or specific statement creates a valid expectation on the customer's part to receive a good or service from the entity (e.g., training on how to use purchased equipment), an implicit promise to transfer goods or services exists that should be accounted for just like an explicit promise to transfer goods or services.

Practical expedients are provided that allow an entity to elect an accounting policy to not identify the following as promised goods or services under certain circumstances: (a) promised goods or services that are immaterial in the context of the contract and (b) shipping and handling activities that occur *after* the customer obtains control of the promised goods. (Shipping and handling activities that occur *before* the customer obtains control of the promised goods are considered fulfillment activities and not promised services that must be further evaluated under ASC 606.)

Some activities performed by the entity, such as setup activities, do not transfer a good or service to the customer. Instead, those activities are necessary for the entity to fulfill the contract and do not themselves represent a good or service transferred to the customer. As a result, they cannot represent a performance obligation for which revenue is recognized. However, depending on the facts and circumstances, the entity may be required to capitalize the costs to perform these activities under ASC 340-40.

1.5.2 Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and accounted for separately. The determining factor in this analysis is whether each promised good or service is distinct. If a promised good or service meets both of the following criteria, it is considered distinct and accounted for separately as a performance obligation, unless the series exception applies:

- *Capable of being distinct*. If a customer can benefit from the promised good or service on its own or by combining it with other resources readily available to the customer, the good or service is capable of being distinct. A promised good or service is capable of being distinct when the entity regularly sells that good or service separately or when the customer could generate an economic benefit from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. For a resource to be readily available to the customer, it must be sold separately either by the entity or another party or it must be a good or service that the customer already has obtained as a result of either a contract with the entity (including the contract under evaluation) or another transaction or event.
- *Distinct within the context of the contract.* If the promised good or service is separately identifiable from other promised goods or services in the contract, it is distinct within the context of the contract. To determine whether a promised good or service is distinct within the context of the contract, the entity must ascertain which of the following best describes its promise within the context of the

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specific contract: (a) the promise is to transfer the promised good or service individually (in which case, the promised good or service is distinct within the context of the contract) or (b) the promise is to transfer a combined item or items to which the promised good or service is an input (in which case, the promised good or service is not distinct within the context of the contract). Indicators focused on the nature and extent of the integration, modification, customization, interdependency and interrelationship between the promised goods and services in the contract are provided to assist in determining whether a promised good or service is distinct within the context of the contract.

The evaluation of whether a promised good or service is distinct should be performed at contract inception for each promised good or service in the contract.

1.5.3 The series exception

A series of distinct promised goods or services that are substantially the same *should* be considered a single performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of: (a) each of the goods or services otherwise being considered satisfied over time and (b) the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services. This exception is commonly referred to as the series exception. Examples of the types of contracts that may, depending on the facts and circumstances, fall under this exception are long-term contracts for hotel management services and transaction processing services.

1.5.4 Accounting consequences

If a promised good or service is distinct, it is considered a performance obligation and accounted for separately unless the series exception applies. If a promised good or service is not distinct, it is combined with other promised goods or services until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the contract.

1.5.5 Portfolio of performance obligations

ASC 606 may be applied to a portfolio of similar performance obligations across multiple contracts for accounting purposes if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the performance obligations. If an entity elects this practical expedient, any estimates or judgments it makes in applying ASC 606 to the portfolio of performance obligations should reflect the portfolio's size and composition.

1.5.6 Warranties

The key accounting question for a warranty is whether it represents or includes a performance obligation (i.e., a distinct service). If a warranty represents or includes a performance obligation, part of the transaction price is allocated to the warranty and recognized as revenue as control of the warranty services is transferred to the customer. If a warranty does not represent or include a performance obligation, no part of the transaction price is allocated to the warranty, and instead, it is accounted for in accordance with the product warranty guidance included in ASC 460, which requires accrual of expected warranty costs.

If the customer has the option to purchase the warranty, it represents a performance obligation and is accounted for separately. If such an option does not exist, the entity must determine whether it is providing: (a) only a warranty that the product complies with agreed-upon specifications (i.e., an assurance-type warranty) or (b) a service (e.g., maintenance) in addition to the assurance-type warranty (i.e., a service-type warranty). If the warranty goes beyond the promise that the product complies with

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agreed-upon specifications, the entity must determine whether it can reasonably account for the assurance-type warranty separate from the service-type warranty. If the entity can reasonably account for the two warranties separate from each other, the assurance-type warranty is accounted for under ASC 460 and the service-type warranty is accounted for as a performance obligation under ASC 606. If the entity cannot reasonably account for the two warranties separate from each other, both warranties are accounted for together as a single performance obligation under ASC 606.

1.5.7 Customer options for additional goods or services (including loyalty programs)

As part of a contract, the entity may provide the customer with options for additional goods or services, such as the following: (a) an option to purchase additional goods or services in the future at a discount, (b) award credits (e.g., points, miles) in customer loyalty programs that can be accumulated and used to obtain additional goods or services in the future or (c) a contract renewal right that can be exercised in the future.

In general, if an option included in a contract gives the customer the right to a discount that is incremental to the range of discounts typically given by the entity on the same goods or services to the same class of customer in the same geographical area or market, the option provides a material right to the customer that it would not have received without entering into the contract. Conversely, if an option included in a contract gives the customer the right to purchase products or services at their standalone selling prices in the future, the option does not provide a material right to the customer that it would not have received without entering into the contract. This type of option is essentially a marketing offer that is not accounted for until the customer exercises the option.

If an option provides a material right to the customer that the customer would not have received without entering into the contract with the entity, the option itself is a performance obligation, and the entity must determine the standalone selling price for the option for purposes of allocating a portion of the transaction price to it. While unlikely to be the case, if there is a directly observable standalone selling price for the option, it should be used for allocation purposes. For the more likely scenario in which a directly observable standalone selling price for the option is not available, the entity must estimate the standalone selling price. Given the difficulties that may arise in doing so, a practical expedient is provided related to estimating the standalone selling price of an option if certain criteria are met.

The transaction price allocated to the option is recognized as revenue when or as the option is exercised, or if it is not exercised, when the option expires unused. This accounting model essentially reflects the customer partially paying in advance for goods and services it will purchase when it exercises the option.

1.6 Step 3: Determine the transaction price

1.6.1 General requirements for determining the transaction price

Transaction price is defined in ASC 606-10-32-2 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).” In addition to the contract terms, the entity’s customary business practices also should be taken into consideration in determining the transaction price.

The entity should assume that the contract will be fulfilled in accordance with its terms and customary business practices for purposes of determining the transaction price. In other words, the entity should not assume or consider cancellation, renewal or modification of the contract.

The transaction price is determined at contract inception and should include any fixed cash consideration and any noncash consideration promised by the customer. The transaction price also should reflect the expected effects of any variable consideration (subject to an overall constraint), such as performance bonuses, rebates and penalties. Depending on the facts and circumstances, the transaction price also may be affected by a significant financing component and consideration payable to the customer.

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1.6.1.1 Sales and similar taxes

An entity may elect an accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the entity's revenue-generating transactions with its customers (e.g., sales taxes, use taxes, value-added taxes, excise taxes and other similar taxes). If an entity elects this accounting policy, it must apply the policy to all sales and similar taxes. If an entity does not elect the accounting policy, it must determine whether it is a principal or an agent with respect to each sales or similar tax assessed on its revenue-generating transactions. If it is a principal, the sales or similar tax is included in the transaction price. If it is an agent, the sales or similar tax is not included in the transaction price.

1.6.1.2 Nonrefundable upfront fees

In general, a nonrefundable upfront fee is only recognized as revenue upfront if it relates to a good or service that is a performance obligation that is satisfied upfront. Otherwise, the nonrefundable upfront fee represents an advance payment for the performance obligations in the contract that will be satisfied later. In either case, the nonrefundable upfront fee is included in the transaction price, which is allocated to the performance obligations and recognized as revenue as those performance obligations are satisfied (either upfront or otherwise).

1.6.2 Noncash consideration

At contract inception, if the fair value of noncash consideration can be reasonably estimated, then that fair value is included in the transaction price. Otherwise, the entity should indirectly determine its fair value using the standalone selling prices of the goods or services being provided to the customer and include that amount in the transaction price.

After contract inception, the fair value of the noncash consideration may vary due to its form (e.g., a share of the customer's stock) or for other reasons (e.g., the entity's performance). Variations in fair value after contract inception that are due to the form of the noncash consideration are not reflected in the transaction price. Variations in fair value after contract inception that are not due to the form of the noncash consideration should be accounted for using the variable consideration guidance in ASC 606.

1.6.3 Variable consideration

Variable consideration can take many forms—refunds, returns, discounts, rebates, performance bonuses, milestone payments, penalties, contract claims and price concessions, just to name a few. The variability in the amount of consideration payable by the customer may be stated in the contract, or it may be caused by an implicit price concession that the entity intends to offer the customer or that the customer has a valid expectation of receiving based on the entity's customary business practices, published policies or specific statements. The variability in the consideration could affect whether the entity is entitled to the consideration and (or) the specific amount of consideration the customer ultimately will have to pay.

With the exception of certain scenarios, such as when an entity is entitled to certain sales- or usage-based royalties, an estimate of the variable consideration to which the entity expects to be entitled should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. This approach to determining the amount of variable consideration that should be included in the transaction price suggests the following two steps should be performed by an entity:

1. Estimate the amount of variable consideration to which the entity expects to be entitled using either the expected value method or the most likely amount method (the specific method used depends on which will better predict the amount of variable consideration in a particular set of facts and circumstances)

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2. Constrain the estimated amount of variable consideration (in whole or in part) such that it is probable that the inclusion of the estimate in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved

The estimate of variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. Any changes in the estimate of variable consideration are treated the same as any other changes in the transaction price. The method used to initially estimate the variable consideration included in the transaction price also should be used when the estimate is reassessed each reporting period.

The preceding variable consideration guidance should not be applied to a sales- and (or) usage-based royalty when the only, or predominant, item(s) to which the royalty relates is the license of IP. The royalties subject to this exception should not be included in the transaction price until the later of: (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation in whole or in part. Sales- and (or) usage-based royalties that are not subject to this exception (e.g., a usage-based royalty that is not related to a license of IP) should be accounted for using the variable consideration guidance otherwise required by ASC 606.

1.6.3.1 Right of return or refund

A customer's right to return a product or receive a refund of fees for services is not considered a performance obligation. Instead, it is treated as variable consideration. As a result, when the entity recognizes revenue, it does so for the amount of the transaction price to which it expects to be entitled, limited to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur (i.e., the transaction price reflects expected returns and refunds).

The entity recognizes a refund liability for the amount received or receivable to which it ultimately does not expect to be entitled as a result of the return or refund right (i.e., the amount it is expected to refund). In addition, for product sales, the entity also separately recognizes an asset representing the right to returned inventory and an adjustment to cost of sales for estimated returns. The refund liability and asset for returned inventory are separately recognized (i.e., they are not netted against each other).

This guidance does not apply to: (a) product exchanges, provided the products are of the same type, quality, condition and price (which have no accounting effect) or (b) product exchanges due to defects (which are accounted for as warranties).

1.6.4 Significant financing component

When a contract includes a significant implicit or explicit benefit of financing to either the entity or the customer (i.e., a significant financing component), that significant financing component is taken into consideration in determining the transaction price, unless an exception applies or the entity qualifies for and elects to apply a practical expedient that allows the entity to ignore that financing component in certain circumstances when determining the transaction price. It is important to note that a financing component may exist in a contract when the payment terms provide for advance or deferred payments. In other words, a financing component in a contract could result in the recognition of interest income or expense.

The objective of reflecting a significant financing component in the transaction price is to recognize revenue in an amount consistent with what the customer would have paid in cash upon the transfer of the promised good or service (i.e., incorporate the time value of money into the accounting for a contract). To adjust the promised consideration for the significant financing component, the entity should use a discount rate consistent with the rate that would be present in a separate financing transaction between the entity and the customer at contract inception. The discount rate is not adjusted after contract inception. Interest income or expense should only be recognized to the extent an accounts receivable,

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contract asset or contract liability has been recognized for the contract. The interest income (when there are deferred payments) or expense (when there are advance payments) that results from including the effects of a significant financing component in the transaction price should be presented separate from the transaction price recognized as revenue.

1.6.5 Consideration payable to the customer

Consideration payable to the customer includes amounts the entity is explicitly required to pay to its customer (e.g., manufacturer paying a slotting fee to a retailer customer) or its customer's customers (e.g., manufacturer giving a rebate to a consumer [which is its customer's customer]). The consideration payable could be labeled a credit, coupon, voucher, rebate, cooperative advertising or slotting fee, among many others. In addition, consideration payable to the customer may be implied based on an entity's past practices or the customer's expectations. An entity may or may not receive something in return for the consideration payable to the customer (e.g., manufacturer pays retailer customer for cooperative advertising or product placement at eye level).

If consideration payable to a customer is variable, it should be accounted for consistent with the variable consideration guidance in ASC 606.

Consideration payable to a customer is reflected as a reduction of the transaction price (and, as a result, a reduction of revenue) unless the entity receives something in return for that consideration that is distinct. For purposes of determining whether the good or service received by the entity is distinct, the entity follows the guidance used to determine whether a promised good or service is distinct and should be accounted for separately as a performance obligation. If the entity receives a distinct good or service from the customer, the amount treated as a cost vs. a reduction of the transaction price depends on the fair value of that distinct good or service.

When some or all of the consideration payable to a customer should be treated as a reduction in the transaction price, that reduction should be reflected upon the later of: (a) when the revenue for the related goods or services is recognized by the entity and (b) when the consideration is paid or promised to the customer (which includes payments made only upon the occurrence of a future event).

1.7 Step 4: Allocate the transaction price to the performance obligations

The overall objective of the guidance on allocating the transaction price is to allocate an amount to each performance obligation (or distinct good or service in a single performance obligation resulting from the series exception) that represents the consideration to which the entity expects to be entitled as a result of transferring control of the underlying goods or services to the customer.

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown (by meeting certain criteria) to be related to one or more (but less than all) performance obligations.

The standalone selling price of a performance obligation is the amount the entity charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances. The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the entity for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the entity is required to estimate a standalone selling price. In making this estimate, the entity should maximize observable inputs and consider all reasonably available and relevant information, which includes

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information specific to the entity, the market, the customer and the customer class. In addition, an entity should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

1.7.1 Changes in the transaction price

Changes in the transaction price that are caused by contract modifications are accounted for in accordance with the contract modification guidance in ASC 606.

Changes in the transaction price, other than those resulting from contract modifications, may be caused by changes in one or more of the numerous factors taken into consideration when estimating the transaction price, such as an entity's expectations about the likelihood of it being entitled to variable consideration. In these situations, any necessary change to the transaction price generally should be allocated to the performance obligations on the same basis and using the same standalone selling prices that were used to allocate the transaction price at contract inception. However, accounting for a change in the transaction price after (but not as a result of) a contract modification depends, at least in part, on the accounting model applied to the modification.

If some or all of the change in transaction price is allocated to a performance obligation that already has been satisfied (i.e., for which revenue already has been recognized), the allocated adjustment amount should be reflected as an increase or decrease to revenue, as appropriate, in the period of the adjustment.

1.8 Step 5: Recognize revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it.

To properly assess when revenue should be recognized, an entity must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time. Central to this evaluation is understanding what constitutes *control having transferred to the customer*.

1.8.1 Transfer of control

In discussing the concept of when control of a good or service transfers to a customer, ASC 606 refers to control of an *asset* transferring. The asset referred to is the good(s) or service(s) in the performance obligation being evaluated for revenue recognition. While the term *asset* is not often used to refer to a service, ASC 606-10-25-25 indicates that "[g]oods 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 has transferred to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits, which includes the customer being able to stop others from directing the use of the asset and receiving substantially all of the related remaining benefits. For this purpose, benefits are considered in terms of the potential cash flows the customer can obtain or save (directly or indirectly) as a result of having control of the asset.

ASC 606 provides several indicators that should be considered in assessing whether control of an asset has transferred to the customer. When present, the following indicators may signal that the customer has the ability to direct the use of the asset (and restrict others' use of the asset) and receive substantially all of the asset's remaining benefits:

- The customer is presently obligated to pay the entity for the transferred asset.
- The customer has legal title to the transferred asset.
- The customer has physical possession of the transferred asset.

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- The customer has the significant risks and rewards of owning the asset.
- The customer has accepted the asset.

It is important to note the following about the presence or absence of an indicator: (a) the presence of an indicator is not determinative evidence that control has transferred to the customer and (b) the absence of an indicator is not determinative evidence that control has not transferred to the customer. Determining whether control of an asset has transferred to a customer often will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

1.8.2 Determining whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, an entity must perform an evaluation at contract inception focused on whether each performance obligation in the contract is satisfied over time or at a point in time. If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the entity's performance at the same time as: (a) the customer receives those benefits and (b) the entity performs and creates those benefits.
- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the entity's performance.
- *No alternative use and an enforceable right to payment.* A performance obligation is satisfied over time if: (a) the asset created by the entity's performance does not have an alternative use to the entity upon its completion and (b) the entity's right to payment for its performance to date is enforceable.

If a performance obligation does not meet any of these criteria, it is considered satisfied at a point in time.

1.8.3 Recognizing revenue for performance obligations satisfied over time

If the performance obligation is considered satisfied over time, the related revenue is recognized over time if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. In the unlikely scenario that an entity is unable to reasonably measure the outcome of a performance obligation, such as may be the case in the early stages of a long-term contract, it should recognize revenue to the extent of the costs incurred to satisfy the performance obligation, but only if it expects to recover those costs. This approach is expected to be used only rarely and only until the entity can reasonably measure the outcome of a performance obligation.

In situations in which the entity can reasonably measure its progress toward complete satisfaction of the performance obligation, it must identify a single method by which to make that measurement. The objective of this method should be to measure the progress made in transferring control of the underlying goods or services to the customer. Output methods or input methods can be used to measure progress toward complete satisfaction of performance obligations. Regardless of which is used, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the underlying goods or services for which control has transferred to the customer and should not reflect any underlying goods or services for which control has not transferred to the customer. In addition, once a method is selected, it should be consistently applied to similar performance obligations in similar circumstances.

A practical expedient is provided that allows an entity to use an output method under which revenue is recognized for the amount the entity has a right to invoice the customer if its right to consideration from that customer directly corresponds to the value received by the customer from the entity's performance completed to date.

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If certain criteria are met, an entity is required to take the costs of uninstalled materials for which control has transferred to the customer out of a cost-based input method used to measure the entity's progress in satisfying the performance obligation, and instead, recognize revenue equal to those costs (i.e., at a zero margin).

Progress toward completion is calculated at the end of each reporting period and used in determining the appropriate amount of revenue to recognize in that period. In general, the calculation is based on the amount of outputs or inputs to date and the estimated total amount of outputs or inputs necessary to satisfy the performance obligation.

1.8.4 Recognizing revenue for performance obligations satisfied at a point in time

If the performance obligation is considered satisfied at a point in time, the related revenue is recognized at the point in time the customer obtains control of the asset underlying the performance obligation.

1.8.5 Customer's unexercised rights (i.e., breakage)

The contract may provide for the customer to prepay for contractual rights it can exercise in the future. Those rights might entitle the customer to goods and (or) services, which obligates the entity to provide or stand ready to provide those goods or services. The prepayment should be recognized as a contract liability. Revenue is recognized by derecognizing the contract liability when the customer exercises its rights in the future. However, customers do not always exercise all of the rights for which they prepaid. Those rights that go unexercised are referred to as breakage.

To the extent an entity expects to be entitled to an amount of breakage, that amount should be proportionately recognized as revenue as the other performance obligations in the contract (i.e., those contractual rights expected to be exercised by the customer) are satisfied. However, the entity will need to apply the variable consideration constraint and conclude it is probable that a significant reversal in cumulative revenue recognized will not occur as a result of proportionately recognizing breakage as revenue as the other performance obligations in the contract are satisfied.

1.8.6 Repurchase agreements (i.e., forwards and call and put options)

Forwards and call and put options are all considered repurchase agreements for accounting purposes. The asset that the entity repurchases or may repurchase can either be the same asset it sold to the customer, a different asset that is substantially the same as the asset it sold to the customer, or a different asset that includes the asset it sold to the customer as a component.

The accounting model applied to a repurchase agreement depends on the nature of the agreement. For a forward or call option, the entity's initial transfer of the asset subject to the forward or call option is not considered a sale for accounting purposes because control of the asset is not considered to have transferred to the customer. Instead, the accounting for a contract that includes a forward or call option depends on whether the repurchase price is less than the original selling price and whether it is part of a sale-leaseback transaction. Depending on the facts and circumstances, these considerations may result in accounting for the forward or call option as a lease or financing arrangement.

For a put option, the entity's accounting requires consideration of whether the repurchase price of the asset is more or less than its original selling price, whether the repurchase price is more than the expected market value of the asset and whether the customer has a significant economic incentive to exercise the put option. Depending on the facts and circumstances, these considerations may result in accounting for the put option as a financing arrangement, a lease or the sale of an asset subject to a right of return.

If a forward or call or put option expires unused, the entity derecognizes any existing related liability and recognizes revenue at that point in time.

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1.8.7 Consignment arrangements and sales to distributors

When an entity ships products to a third party (e.g., a dealer or distributor) and that third party sells the products to consumers, the entity needs to consider whether the third-party seller obtains control over the products received from the entity prior to selling them to the consumer. In some cases, inventory shipped to third-party sellers is held on consignment, which means the third-party seller has not obtained control of the products received. ASC 606 provides indicators that should be considered in determining whether the third-party seller is holding the inventory on consignment. When products shipped to a third-party seller are considered to be held on consignment, a performance obligation has not been satisfied (and no revenue is recognized), despite the fact that the products have been delivered to the third-party seller. When products shipped to a third-party seller are not held on consignment, the performance obligation is satisfied when control of the products has transferred to the third-party seller. It would be inappropriate for the entity to delay recognizing revenue (e.g., until the third-party seller sells the products to consumers) when control of the products has transferred to the third-party seller.

1.8.8 Bill-and-hold arrangements

A bill-and-hold arrangement refers to a contract in which the customer purchases products and is billed for the products, but the entity retains physical possession of the products for a period of time. The key question in a bill-and-hold arrangement is whether control of the goods has transferred to the customer, despite the fact the goods are not in the customer's physical possession. Given the difficulty in answering this question, an entity is required to evaluate whether control has transferred to the customer using: (a) the general concept of control and indicators of control transfer (other than physical possession) and (b) criteria specifically related to bill-and-hold arrangements. The criteria specifically related to bill-and-hold arrangements require an entity to consider whether: (a) there is a substantive reason for the bill-and-hold arrangement, (b) the products have been separately identified as belonging to the customer, (c) the products are ready to be physically transferred to the customer and (d) the entity is prohibited from using the products and redirecting them to other customers.

Revenue is recognized in a bill-and-hold arrangement prior to the customer taking physical possession of the product only if: (a) the entity's evaluation of the general concept of control transfer and the general indicators of control transfer (other than physical possession) results in a conclusion that control of the product has transferred to the customer and (b) the criteria specifically related to bill-and-hold arrangements have been met.

If an entity concludes control of the products subject to a bill-and-hold arrangement has transferred to the customer prior to shipment, consideration should be given to whether the entity's obligation to hold the products for a period of time after it transferred control to the customer represents a performance obligation that should be accounted for separately.

1.8.9 Customer acceptance

Customer acceptance provisions require acceptance by a customer that the good or service provided by the entity meets agreed-upon specifications. The question that arises when customer acceptance provisions are included in a contract is whether acceptance must be obtained from the customer before the entity is able to conclude that control of the good or service has transferred to the customer.

If the entity can objectively determine that the goods or services meet the agreed-upon specifications (e.g., specified size and weight characteristics) before the customer accepts the goods or services, acceptance by the customer is not necessary to conclude that control has transferred to the customer. Conversely, the inability to objectively determine whether the goods or services meet the agreed-upon specifications before the customer accepts the goods or services makes it necessary for the entity to obtain customer acceptance before it concludes control has transferred to the customer. As a result, if customer acceptance is based on subjective criteria (e.g., customer satisfaction), then the entity cannot conclude that control has transferred to the customer until the customer provides acceptance.

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If the contract requires the entity to provide products to the customer for trial or evaluation purposes, consideration must be given to when the customer is obligated to pay. If the customer is not obligated to pay until the trial period lapses, control of the products does not transfer to the customer until the trial period lapses or the customer accepts the products.

1.9 Licensing and rights to use

Licensing involves an entity (i.e., licensor) providing a customer (i.e., licensee) with a right to use its IP, which may come in many different shapes and sizes. Examples of IP that may be the subject of a license include software, movies, trademarks, patents, franchises, music, technology and copyrights.

It is important to note that the entity still owns the IP subject to the license (i.e., ownership of the IP does not transfer to the customer). The same five steps are applied to a contract that includes a license of IP as are applied to other contracts. However, given the unique nature of IP, additional implementation guidance was provided in ASC 606 with respect to applying certain steps in the revenue recognition model to contracts that include a license of IP.

1.9.1 Identifying the performance obligations in a contract that includes a license of IP

In some situations, a contract may only include a license of IP. In other situations, a contract may include one or more licenses of IP in addition to other promised goods or services (e.g., a software license and installation services). In these situations, the entity must consider whether the license of IP is distinct from the other promised goods or services in the contract using the same guidance used to determine whether any promised good or service is distinct from any other promised good or service in the contract. The following are examples of licenses of IP that are not distinct from certain other promised goods or services in the contract:

- A license of IP included with the sale of a tangible good, and the license of IP is an integral component to the functionality of the good (e.g., an automobile with embedded software)
- A license of IP included with the sale of a service, and the customer does not benefit from the license of IP absent the service (e.g., a SaaS arrangement)

1.9.2 Determining whether a performance obligation that includes a license of IP is satisfied over time or at a point in time

The entity must determine whether the transaction price allocated to the performance obligation that includes a license should be recognized over time or at a point in time. The manner in which this determination is made depends on whether the performance obligation only includes a license of IP or a license of IP and other promised goods or services.

1.9.2.1 Performance obligation only includes a license of IP

When the performance obligation only includes a license of IP, the key question in determining whether the related revenue should be recognized over time or at a point in time is whether: (a) the IP being licensed has standalone functionality, in which case it represents a right to use the IP (except in limited circumstances) for which the allocated transaction price should be recognized at a point time, or (b) the IP being licensed does not have significant standalone functionality (i.e., it is symbolic), in which case it represents a right to access the IP over time for which the allocated transaction price should be recognized over time.

To have significant standalone functionality, a substantial part of the IP's utility must come from its ability to provide benefit or value to the customer in and of itself (i.e., the entity does not need to undertake any additional activities over the license period for the IP to provide benefit and value to the customer). IP with significant standalone functionality includes IP that provides benefits or value to the customer because it is capable of processing a transaction, executing a function or task or being played or aired.

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When the license of the IP is considered a right to use the IP, the entity should consider the indicators for transfer of control for purposes of determining whether control was transferred at the point in time the license was granted or at another point in time (such as when the license key is provided to the customer for a software license). When the license of the IP is considered a right to access the IP, the entity has to identify an appropriate method by which to measure its progress toward complete satisfaction of the right to access the IP. Regardless of whether a license is considered a right to use or a right to access the IP, revenue related to a license of IP should not be recognized before both of the following occur:

- A copy of the IP has been provided or otherwise made available to the customer.
- The period over which the customer is able to use and benefit from its rights to the IP has started (i.e., the license period has begun).

The need to meet the second of these criteria before revenue is recognized results in revenue related to a license renewal being recognized no earlier than the beginning of the renewal period.

1.9.2.2 Performance obligation includes a license of IP and one or more other promised goods or services

When the performance obligation includes a license of IP and one or more other promised goods or services (because they are not distinct from each other), the entity must determine whether the performance obligation is satisfied at a point in time or over time, and if it is the latter, what method it should use to measure progress toward the complete satisfaction of the performance obligation. In doing so, the entity should still take into consideration whether the license of IP provides the customer with a right to use the IP or a right to access the IP.

1.10 Principal vs. agent (i.e., gross vs. net)

The principal vs. agent guidance is only applied when another party is involved with the entity in providing the specified goods or services to the customer. When that is the case, there are two key steps:

- Identifying the specified goods or services being provided to the customer
- Determining whether the entity obtains control of the specified goods or services before transferring control of those goods or services to the customer

1.10.1 Identifying the specified goods or services

The same analysis used to identify the performance obligations in a contract also is used to identify the specified goods or services to which the principal vs. agent guidance is applied when another party is involved in providing those goods or services to the customer. As such, identifying the specified goods or services involves identifying all of the promises to provide goods or services in the contract and then determining whether those promised goods or services (or groups of those promised goods or services) are distinct. The concept of distinct used for this purpose is the same as the concept of distinct used to identify performance obligations.

1.10.2 Determining whether the entity obtains control of a specified good or service

Once the specified goods or services have been identified, the entity must determine whether it controls each of the specified goods or services before those goods or services are transferred to the customer. If so, the entity is acting as a principal and should include the gross amount of consideration related to each of the specified goods or services in the transaction price (which is the amount ultimately recognized as revenue). If not, the entity is acting as an agent and should include the net fee or commission to which it expects to be entitled for arranging to have another party provide the specified good or service to the customer in the transaction price. This may be the net amount it retains after collecting the gross amount from the customer and remitting part of that amount to the other party providing the good or service to the customer.

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When another party is involved with the entity in providing the goods or services that make up a specified good or service to the customer, ASC 606 describes three situations in which the entity is a principal with respect to the specified good or service because it obtained control of the good, other asset, service and (or) right to a service that make up the specified good or service before control transferred to the customer. In some situations, an analysis of the facts and circumstances will fit conclusively within one of those three situations, in which case no further analysis would be required. However, in other situations, an analysis of the facts and circumstance will not conclusively fit within one of those three situations, in which case additional analysis will be needed to determine whether the entity is a principal with respect to the specified good or service. The additional analysis should focus on the following indicators: (a) does the entity have primary responsibility for fulfillment (if so, that is an indicator the entity is a principal), (b) does the entity have inventory risk (if so, that may be an indicator the entity is a principal) and (c) does the entity have discretion in setting prices (if so, that may be an indicator the entity is a principal).

1.11 Onerous contracts

ASC 606 does not provide guidance on how to account for onerous (i.e., loss) contracts. However, existing guidance in legacy GAAP that addresses certain types of onerous contracts was retained. In some cases, this guidance was amended to reflect the fact that ASC 606 and ASC 340-40 will factor into the determination as to whether a contract is onerous, and if so, the amount of loss that is recognized. Some of the guidance retained and amended relates to accounting for losses on: (a) separately priced extended warranty and product maintenance contracts (ASC 605-20), (b) construction-type and production-type contracts (ASC 605-35) and (c) contracts for software systems for which there is significant production, modification or customization of the software (ASC 985-605-25-7).

1.12 Contract costs

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The two categories of costs addressed in ASC 340-40 include: (a) costs to fulfill a contract and (b) costs to obtain a contract.

1.12.1 Costs to fulfill a contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of types of fulfillment costs for which other accounting guidance should be applied include inventory (ASC 330), costs of internal-use software (ASC 350-40), costs of property, plant and equipment (ASC 360) and costs of software to be sold, leased or marketed (ASC 985-20). If there is specific guidance applicable to the accounting for a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance.

Costs to fulfill a contract for which there is no other applicable guidance must be capitalized when certain criteria are met. An entity may not choose to expense such costs when the criteria are met.

1.12.2 Costs to obtain a contract

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. The entity must be obligated to make a payment only as a result of entering into the contract for the related cost to be considered an incremental cost of obtaining the contract. The incremental costs to obtain a contract should be capitalized if the entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less.

The costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained

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(e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

1.12.3 Amortization of capitalized costs

The amortization method and period used to amortize capitalized costs related to obtaining or fulfilling a contract (including an anticipated contract, such as a contract renewal) should be systematic and consistent with how and when the related goods or services are transferred to the customer. For example, if the capitalized costs relate to a service that is transferred to the customer continuously and evenly over the contract term, then straight-line amortization of those costs over the contract term would typically be appropriate.

When the capitalized costs relate to goods or services expected to be transferred under both the initial contract and one or more expected contract renewal(s), the expected contract renewals are reflected in the amortization period.

1.12.4 Impairment of capitalized costs

Costs capitalized in accordance with ASC 340-40 are tested for impairment by comparing the carrying amount of the capitalized costs to the following calculated amount: (a) the contract consideration an entity expects to receive in the future *plus* (b) the contract consideration the entity has already received, but not yet recognized as revenue *minus* (c) the direct costs related to transferring goods or services that remain to be recognized as an expense under the contract. The time period reflected in this impairment test should take into consideration expected contract renewals and extensions with the same customer. In addition, contract consideration is the transaction price otherwise determined under ASC 606 reduced by the amount the entity does not expect to collect from the customer due to its credit risk and increased to remove the effects of the variable consideration constraint (if any). If the carrying amount of the capitalized costs is greater than the calculated amount, an impairment loss is recognized.

Before recognizing an impairment loss on costs capitalized in accordance with ASC 340-40, an entity should first evaluate whether any impairment losses exist on certain other assets related to its contracts, such as inventory or capitalized costs of software to be sold or leased. In addition, an entity should recognize any necessary impairment loss on costs capitalized in accordance with ASC 340-40 before it tests and recognizes an impairment loss on other assets within the scope of ASC 340 (e.g., preproduction costs capitalized in accordance with the applicable guidance in ASC 340-10), ASC 360 (e.g., property, plant and equipment) or ASC 350 (e.g., goodwill).

Once an impairment loss is recognized, it is not reversed under any circumstances.

1.13 Presentation

Application of the guidance in ASC 606 may result in the recognition and presentation on the balance sheet of a contract asset or liability for the difference between the entity's performance (i.e., the goods or services transferred to the customer) and the customer's performance (i.e., the consideration paid by, and unconditionally due from, the customer). However, before recognizing a contract asset or liability, the entity must first consider whether an accounts receivable should be recognized.

When the entity has an unconditional right to consideration from the customer, it should recognize an accounts receivable. An unconditional right exists when only the passage of time is required before customer payment. The amount of accounts receivable initially recognized and the subsequent accounting for that receivable should be based on the guidance in the ASC otherwise applicable to accounts receivable. If there is a difference between the initial amount of accounts receivable recognized and the corresponding amount of revenue recognized in accordance with ASC 606, this difference should be recognized as an expense (an impairment loss or credit loss expense, as appropriate).

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A contract liability arises if the customer's performance is greater than that of the entity (i.e., the consideration paid plus any amount recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer). The contract liability is recognized upon the earlier of the customer making a payment or becoming unconditionally obligated to make a payment that results in the customer's performance being greater than the entity's performance.

A contract asset arises if the entity's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is more than the consideration paid or recognized as a receivable). Once recognized, a contract asset is evaluated for impairment or credit losses in accordance with the guidance applicable to accounts receivable.

Contract liability and *contract asset* are not the prescribed descriptors for the related liability and asset in the balance sheet. However, if a descriptor other than *contract asset* is used, it should be clear that the asset represents something other than a receivable.

Typically, a refund liability to the customer (which may arise, for example, when the customer has the right of return) should not be included with the contract liability for presentation purposes.

1.14 Disclosure

Many new qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): "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."

The disclosures required to achieve this objective fall into three primary categories: (a) information about the entity's contracts, (b) information about the judgments (and changes in those judgments) made in applying ASC 606 that have a significant effect on when and how much revenue is recognized related to the entity's contracts and (c) information about the fulfillment costs and incremental costs to obtain contracts that the entity capitalized in accordance with ASC 340-40.

The extent of the required disclosures depends on whether the entity is a public entity (more required disclosures) or nonpublic entity (less required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required for interim periods. However, when an entity applies ASC 606 and ASC 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and ASC 340-40 in its annual financial statements, the entity must provide all the required annual disclosures in those interim financial statements.

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2. Introduction

2.1 Background

In 2014, the FASB and IASB issued substantially converged final standards on revenue recognition. These final standards were the culmination of a joint project between the Boards that spanned many years. The FASB's ASU 2014-09 provides a robust framework for addressing revenue recognition issues and replaced almost all pre-existing revenue recognition guidance in U.S. GAAP (i.e., legacy GAAP), including industry-specific guidance and SAB Topic 13 (which was also part of legacy GAAP for public entities). Implementation of the robust framework provided by ASU 2014-09 should result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets.

The guidance added to the ASC by ASU 2014-09 primarily includes ASC 606, ASC 340-40 and ASC 610-20. As discussed in Section 2.2.3, the FASB has revised the new guidance several times. The basis for this guide is the revised new guidance as of April 30, 2024.

For ease of use, definitions for acronyms and titles for ASC topics and subtopics and other accounting literature referred to in this guide are included in Appendix B.

2.2 Status

2.2.1 TRG activities

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint TRG. While the IASB discontinued its formal involvement in the Joint TRG in early 2016, the FASB TRG held meetings in April and November 2016. Even though the FASB TRG has not met since November 2016, it has not been discontinued.

The TRG has discussed many implementation issues submitted by constituents with the primary purpose being to help inform the FASB and IASB as to whether additional standard setting may be necessary to resolve a particular issue. While the TRG does not issue guidance, the FASB has provided Revenue Recognition Implementation Q&As (FASB RRI Q&As), which provide the relevant materials for each issue discussed. If the TRG discussions on an issue led the FASB and (or) IASB to believe additional standard setting was necessary, they added the issue to their respective agendas. While the FASB and IASB moved in lockstep when addressing several of the TRG issues, there were also several issues where that was not the case. For many TRG issues, the FASB decided to undertake additional standard setting (e.g., provide clarifications or additional guidance), while the IASB decided not to do so. As a result, while the FASB's and IASB's guidance (as amended) continues to be converged in many important respects, the extent of that convergence is less than it was when ASU 2014-09 and IFRS 15 were originally issued. Refer to our U.S. GAAP vs. IFRS comparisons white paper, which highlights the significant differences between ASC 606 and IFRS 15.

2.2.2 AICPA activities

In conjunction with issuance of the new guidance, the AICPA organized sixteen industry-specific task forces to identify and provide guidance on implementation issues in specific industries. The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition guide that provides helpful discussion and illustrative examples on how to apply the new guidance to contracts 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 and timeshare.

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2.2.3 Revisions to the new guidance since its issuance

Based on the TRG's and AICPA industry-specific task forces' activities and other sources of feedback, the FASB has made several revisions that impacted the new guidance since its issuance, which are included in the following ASUs:

- ASU 2015-14
- ASU 2016-08
- ASU 2016-10
- ASU 2016-12
- ASU 2016-20
- ASU 2017-05
- ASU 2017-10
- ASU 2017-13
- ASU 2017-14
- ASU 2018-08
- ASU 2018-18
- ASU 2019-08
- ASU 2020-05
- ASU 2020-10
- ASU 2021-02

2.3 Significant changes

While the policies used by almost all entities to account for revenue and certain related costs were affected by the new guidance, the degree of change to a specific entity's revenue recognition policies and the effects the changes have on the entity's financial statements varied depending on the nature and terms of the entity's revenue-generating transactions. In addition, entities in some industries were affected by the new guidance more than entities in other industries. For example, while the revenue recognition policies for the normal course transactions of a traditional retailer changed so that they are aligned with the principles and guidance in ASC 606, those changes may not have had a significant effect on the timing and amount of revenue recognized by the retailer. Conversely, the effects of the changes to a technology entity's revenue recognition policies to align them with the principles and guidance in ASC 606 may have resulted in significant changes to the timing and amount of revenue recognized by that entity. It is important to note, however, that entities in virtually all industries were significantly affected by the disclosure requirements in the new guidance. For additional information about how certain industries were affected by the new guidance, refer to our Industry revenue recognition white papers.

Examples of significant changes incorporated into the new guidance that may have affected how an entity accounts for its contracts with customers include the following:

- *Transfer of control model*. Focus on the transfer of control, instead of the transfer of risks and rewards of ownership (which is used pervasively in legacy GAAP), for purposes of determining when to recognize revenue.

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- *Variable consideration*. Use of a model that may result in estimates of variable consideration being included in the transaction price (and recognized as revenue) sooner than they would be under legacy GAAP.
- *Significant financing component*. Incorporation of a significant financing component (caused by either advance payment or deferred payment terms with the customer) into the measurement of revenue (with certain exceptions), which is only done under legacy GAAP in the context of accounting for long-term receivables.
- *Licenses*. Use of one comprehensive approach to account for all licenses and rights to use IP instead of the limited-scope industry-specific models in legacy GAAP.
- *Multiple-element arrangements*. Use of one comprehensive approach to account for multiple-element arrangements instead of the general model (i.e., ASC 605-25) and industry-specific models in legacy GAAP.
- *Contract costs*. Requirement to capitalize certain costs related to a contract with the customer (e.g., sales commissions, setup costs) under certain circumstances instead of having the option to do so in certain cases under legacy GAAP.

In addition, the disclosure requirements in the new guidance caused the volume of revenue-related information disclosed in the financial statements to significantly increase, particularly for public entities.

These and other changes are highlighted throughout the remainder of this guide. Whether, and the degree to which, any of the changes introduced by the new guidance affect an entity can only be determined after performing a comprehensive analysis of an entity's contracts in the context of that guidance.

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3. Scope

3.1 General scope requirements

ASC 606 addresses revenue from contracts with customers. As such, key to understanding what is within the scope of ASC 606 are the definitions of revenue and customer:

- Revenue (Master Glossary of the ASC): "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."
- Customer (ASC 606-10-15-3): "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."

While the scope of ASC 606 is limited to revenue from contracts with customers, as discussed in Appendix A, many aspects of the guidance in ASC 606 also are applicable to certain transfers of nonfinancial assets and in substance nonfinancial assets to counterparties other than customers.

All contracts with customers fall within the scope of ASC 606 except for those noted in the following table.

Contracts with customers not within the scope of ASC 606	Applicable ASC Topic
Lease contracts	842 (see Section 3.3.2)
Insurance contracts and other contracts within the scope of ASC 944	944
Various contractual rights or obligations related to financial instruments within the scope of other applicable accounting guidance, such as: • Accounts receivable (Note 1) • Investments in debt securities • Investments in equity securities • Equity method investments • Investments in joint ventures • Derivative instruments and hedging activities • Transfers and servicing of financial assets • Liabilities (Note 2) • Debt	310, 320, 321, 323, 325, 405, ASC 470, 815, 825 and 860
Guarantees, except for product or service warranties (see Section 6.5)	460
Nonmonetary exchanges in which the counterparties are in the same line of business and are entering into the exchange to facilitate sales to existing or potential customers	845

Note 1: While ASC 606 does not provide guidance on how to account for accounts receivable, accounting for contracts with customers often gives rise to accounts receivable, which is discussed in Section 14.1.

Note 2: While ASC 606 does not provide guidance on how to account for liabilities in general, accounting for contracts with customers does give rise to contract liabilities, which are discussed in Section 14.2.

There are no other scope exceptions in ASC 606 for certain industries that have had their own contract-based revenue recognition guidance in legacy GAAP. Examples of industries that are subject to ASC 606

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and that no longer have their own separate industry-specific revenue recognition guidance include the construction, real estate, software and franchising industries.



Spotlight on change

Legacy GAAP on revenue recognition was developed in a piecemeal manner. In many cases, specific guidance was developed for a particular industry, transaction or contractual provision, which resulted in limited applicability of the related guidance. One of the most significant aspects of ASC 606 is its broad applicability and the fact that it superseded virtually all revenue-related legacy GAAP, including the vast majority of its industry-specific guidance.

3Q.1.1 Is a collaborator or partner a customer?

In most cases, determining whether the counterparty to a contract meets the definition of a customer will not require much analysis. In other cases, such as contracts with a collaborator or partner (e.g., two companies agreeing to collaborate on the development of a new drug) in the scope of ASC 808, more analysis will be required to determine whether the collaborator or partner meets the definition of a customer. In addition, the terms of a contract and the related facts and circumstances may indicate that the counterparty is a customer for only a portion of the contract and the contract is only partially within the scope of ASC 606 (see Section 3.3).

The need to determine whether the counterparty in a collaborative agreement is a customer or a collaborator is addressed in ASC 808, which notes the following:

- Certain transactions between collaborative participants should be accounted for as revenue under ASC 606 when the collaborative arrangement participant is a customer in the context of a unit of account. In these situations, all the guidance in ASC 606 should be applied, including recognition, measurement, presentation and disclosure requirements.
- When an entity is assessing whether the collaborative arrangement or a part of the arrangement is within the scope of ASC 606, the unit of account that should be assessed is the distinct good or service as determined in accordance with the guidance in ASC 606.
- In a transaction with a collaborative arrangement participant that is not directly related to sales to third parties, presenting the transaction together with revenue recognized under ASC 606 is precluded if the collaborative arrangement participant is not a customer.

Paragraph BC56 of ASU 2014-09 indicates that it may be appropriate to account for a collaborative agreement by analogizing to ASC 606 provided there is not more relevant guidance in the ASC with respect to how to account for a particular collaborative agreement. In addition, ASC 808-10-45-3 indicates that presentation of arrangements that are outside the scope of authoritative accounting literature should be determined by analogizing to other guidance in the ASC when possible or by consistently applying a reasonable, rational accounting policy election when no appropriate analogy is available. However, the circumstances under which an entity should present transactions that arise from a collaborative arrangement as revenue is limited, as discussed earlier.

3Q.1.2 Who is the customer in a service concession arrangement?

For service concession arrangements within the scope of ASC 853, the grantor is considered the customer of the operation services provided by the operating entity.

3Q.1.3 Can revenue result from transactions with counterparties that are not customers?

Revenue can result from the following types of transactions with counterparties that are not customers:

- Transactions within the scope of ASC 905-605, such as certain income replacement and subsidy programs that benefit agricultural producers and agricultural cooperatives

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- Transactions within the scope of ASC 980-605, such as those related to alternative revenue programs of regulated utilities
- Contributions received by not-for-profit entities and health care entities within the scope of ASC 958-605 and ASC 954-605, respectively (see Question 3Q.1.4 and Section 3.3.1)

Because these transactions are with parties other than customers, the guidance in ASC 606 does not apply and the guidance in legacy GAAP remains applicable. In addition, revenue from these types of transactions should not be classified with revenue from contracts with customers (or exchange transactions for not-for-profit entities) on the income statement (or statement of activities for not-for-profit entities).

3Q.1.4 Does ASC 606 apply to not-for-profit entities?

ASC 606 applies to all contracts with customers. Therefore, to the extent a not-for-profit entity enters into arrangements that are considered exchange transactions, it will be required to apply the guidance in ASC 606. However, the FASB staff and TRG did discuss whether contributions are within the scope of ASC 606. This issue was addressed in Question 6 of the FASB RRI Q&As, and the FASB staff and TRG concluded that contributions are not within the scope of ASC 606 because they are nonreciprocal transfers. As a result, contributions should continue to be accounted for in accordance with ASC 958-605.

When a transaction includes both an exchange transaction component and a contribution component, only the exchange component is within the scope of ASC 606, as discussed in Section 3.3.1.

In some cases, determining whether a transaction entered into by a not-for-profit entity represents a contribution or exchange transaction can be complex. As a result, in 2018 the FASB issued ASU 2018-08, which addressed two issues that deal with: (a) characterizing grants and contracts as reciprocal transactions (i.e., exchange transactions) or nonreciprocal transactions (i.e., contributions) and (b) distinguishing between conditional and unconditional contributions. The following excerpt from the definition of a contribution in the Master Glossary of the ASC, as updated by ASU 2018-08, not only includes the definition of a contribution, but also includes the definition of exchange transaction, both of which are critical to understanding whether a contract entered into by a not-for-profit entity is within the scope of ASC 606 or ASC 958-605:

> 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:
>
> a. Exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately commensurate value
>
> b. Investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners
>
> c. Other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers.

With respect to whether grants and contracts should be characterized as exchange transactions or contributions, the ASU:

- Provides implementation guidance related to determining whether a resource provider (e.g., government entity) receives commensurate value from the recipient entity (e.g., not-for-profit entity); for example:
  - The value considered in determining whether commensurate value was received by the resource provider would be the direct value it receives, not the indirect value it receives in the form of an overall potential public benefit.

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  - An expressed intent by both parties for the grant or contract to represent an exchange of commensurate value would be indicative of an exchange transaction. Conversely, solicitation of assets by the recipient without the intent of transferring goods or services of commensurate value would be indicative of a contribution.
  - The resource provider having sole discretion in determining the amount of the transferred assets would be indicative of a contribution.
- Clarifies that transfers between a resource provider (e.g., Medicare reimbursements, state tuition assistance) and a recipient (e.g., hospital, university) in connection with an existing exchange transaction between the recipient and an identified customer (e.g., hospital and patient, university and student) would not be contributions and would be accounted for in accordance with other applicable guidance (e.g., ASC 606).
- Provides five examples illustrating how to determine whether a grant or contract is a contribution or exchange transaction.

3Q.1.5 Are credit card fees charged by the card-issuing bank within the scope of ASC 606?

The FASB staff and TRG discussed whether credit card fees charged by the card-issuing bank are within the scope of ASC 606. This issue was addressed in Question 1 of the FASB RRI Q&As, and the FASB staff and TRG concluded that credit card fees charged by the card-issuing bank are not within the scope of ASC 606 because they are within the scope of ASC 310. As a result, credit card fees charged by the card-issuing bank should continue to be accounted for in accordance with ASC 310.

Card-issuing banks should not take the FASB staff's and TRG's conclusion on credit card fees to mean that all of the types of arrangements card-issuing banks enter into with their customers are outside the scope of ASC 606. No entities or industries were excluded from the scope of ASC 606, only certain types of transactions and contracts within the scope of other guidance (see Section 3.1), such as those transactions and contracts within the scope of ASC 310. In addition, a card-issuing bank should not account for its contracts based solely on how they are labelled. In other words, if a contract labelled as a credit card lending arrangement includes promised goods or services beyond credit card lending services within the scope of ASC 310, the card-issuing bank should evaluate whether the transfer of those additional promised goods or services fall within the scope of ASC 606 or other guidance. If they fall within the scope of ASC 606 or ASC 610-20 (see Appendix A), the guidance in Section 3.3 would be applied to separate the ASC 310 component of the arrangement from the ASC 606 or ASC 610-20 component.

3Q.1.6 Are cardholder rewards programs within the scope of ASC 606?

The FASB staff and TRG discussed whether cardholder rewards programs are within the scope of ASC 606. This issue was addressed in Question 2 of the FASB RRI Q&As, and the FASB staff and TRG did not provide a broad-based conclusion that all such programs are or are not within the scope of ASC 606 because of the complex nature of many of these programs and the answer to the question being dependent on the specific facts and circumstances of a particular program. However, the FASB staff and TRG did conclude that if the fees associated with a cardholder rewards program are within the scope of ASC 310, the program is not within the scope of ASC 606. As such, card-issuing banks that have cardholder rewards programs will need to determine whether their programs are completely or partially within the scope of ASC 310 and (or) ASC 606. Making this determination will require significant judgment to be exercised and careful consideration of all the facts and circumstances related to a particular cardholder rewards program. If such a program is partially within the scope of ASC 606, the guidance in Section 3.3 would be applied to separate the ASC 606 component from the non-ASC 606 component.

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3Q.1.7 Are incentive-based capital allocations, such as carried interest, within the scope of ASC 606?

An asset manager may receive incentive-based capital allocations, such as carried interest, in connection with providing asset management services to its customers. A key question with respect to accounting for these incentive-based capital allocations is whether the arrangements that provide for such allocations should be accounted for as: (a) revenue under ASC 606 or (b) equity interests under other applicable guidance in the ASC, such as the guidance on consolidation or the equity method of accounting. This issue was addressed in Question 3 of the FASB RRI Q&As. The views expressed regarding how asset managers should account for arrangements that provide for incentive-based capital allocations were as follows:

- Many TRG members concluded that such arrangements should be accounted for as revenue under ASC 606. Only a few TRG members indicated that they understood a view that such arrangements should be accounted for as an equity interest under other applicable guidance in the ASC.
- The FASB staff involved in the TRG discussions stated their view that such arrangements should be accounted for as revenue under ASC 606.
- All seven members of the FASB were present during the TRG's discussions, and they shared a view that such arrangements should be accounted for as revenue under ASC 606.
- The SEC staff observer present during the TRG's discussions indicated that he expects the SEC staff to accept a position that such arrangements should be accounted for as revenue under ASC 606. However, he also indicated that there may be a basis to account for such arrangements as equity interests under other applicable guidance in the ASC.

To the extent an asset manager accounts for incentive-based capital allocations (e.g., carried interest) as equity interests, the asset manager should ensure it has fully analyzed the accounting for the arrangements that provide for such allocations in the context of the consolidation models in ASC 810, the equity method of accounting in ASC 323 and (or) other applicable guidance in the ASC. Application of the consolidation model in ASC 810 could result in consolidation of the funds by the asset manager. In addition, the asset manager should ensure that its other accounting policies are internally consistent with the conclusion that incentive-based capital allocations (e.g., carried interest) are equity interests.

If an entity that previously accounted for incentive-based capital allocations under legacy revenue guidance elects to change its accounting policy for these allocations to account for such arrangements as equity interests, this change would constitute a change in accounting policy under ASC 250. This would require, among other provisions, retrospective application of the change and concluding that the accounting for such arrangements as equity interests is preferable to accounting for such arrangements as revenue. If an entity has an accounting policy to account for arrangements with incentive-based capital allocations as equity interests, and other applicable guidance in the ASC results in applying the equity method of accounting to those equity interests, careful consideration should be given to the income statement presentation of any related equity method income or loss.

3Q.1.8 Is the income (or servicing fees) financial institutions earn from (or charge for) servicing and subservicing activities within the scope of ASC 606?

The FASB staff and TRG discussed whether the income (or servicing fees) financial institutions earn from (or charge for) their servicing and subservicing activities is within the scope of ASC 606. This issue was addressed in Question 4 of the FASB RRI Q&As, and the FASB staff and TRG concluded that if the income (or servicing fees) financial institutions earn from (or charge for) servicing and subservicing activities is within the scope of ASC 860, such income (or fees) is not within the scope of ASC 606. While ASC 860 does not explicitly address recognizing revenue from servicing fees, the FASB staff and TRG

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concluded that the subsequent accounting guidance provided for servicing assets and liabilities provided in ASC 860 implicitly addresses the recognition of such fees.

3Q.1.9 Are deposit-related fees charged by financial institutions within the scope of ASC 606?

The FASB staff and TRG discussed whether the deposit-related fees charged by financial institutions are within the scope of ASC 606. This issue was addressed in Question 5 of the FASB RRI Q&As, and the FASB staff and TRG concluded that deposit-related fees charged by financial institutions are within the scope of ASC 606. While there is a scope exception from ASC 606 for liabilities within the scope of ASC 405 (which includes deposit liabilities of financial institutions), the FASB staff and TRG concluded that the scope exception does not apply to the deposit-related fees charged by financial institutions because ASC 405 does not provide an accounting framework for recognizing those fees. The *Implementation Considerations* section of Question 5 includes considerations identified by the FASB staff related to a financial institution's application of ASC 606 to deposit-related fees.

3Q.1.10 Are fees from financial guarantees within the scope of ASC 606?

The FASB staff and TRG discussed whether fees from financial guarantees are within the scope of ASC 606. The FASB staff and TRG concluded that fees from financial guarantees within the scope of ASC 460 are not within the scope of ASC 606, as noted in paragraph BC8 of ASU 2016-20. To eliminate the confusion on this question created by certain conforming amendments made by ASU 2014-09, the FASB made certain technical corrections in ASU 2016-20 by updating ASC 310-10-60-4.

3Q.1.11 Are potential refunds or credits that may be due to a customer as part of a service level agreement (SLA) within the scope of ASC 606?

An SLA generally defines the metrics that must be met by an entity when providing services and often includes penalties owed to a customer if those metrics are not met. For example, a cloud service provider may promise that their online services will be up 99.99% of the time and for each day the uptime metric is not met, they will make a specific payment to the customer. The scope of ASC 606 excludes guarantees (other than a product or service warranty) within the scope of ASC 460. However, potential refunds or credits that may be due to a customer as part of an SLA are considered a guarantee or indemnification of an entity's own future performance, which is a type of guarantee that ASC 460-10-15-7(i) states is excluded from the scope of ASC 460. As a result, these clauses would be within the scope of ASC 606 and accounted for as variable consideration to be estimated as part of determining the transaction price in the contract.

3Q.1.12 Are contracts that include trade-in rights within the scope of ASC 606?

In certain contracts for the sale of a product to a customer, an entity may agree to offer its customer a right to trade in that product. For example, an entity may provide the customer with the ability to trade in the original product for a fixed price if the customer purchases an upgraded or newer version of that specific product once it is developed. Contracts with these features ("trade-in rights") should first be assessed to determine whether the trade-in right is within the scope of other guidance, such as ASC 460 on guarantees. Specifically, there is a scope exception in ASC 460-10-15-7(k) that excludes a "sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated at the customer's request to reacquire the equipment)." This scope exception goes on to state that such arrangements should be evaluated using the guidance on repurchase agreements in ASC 606.

When the trade-in right contains a fixed price, we generally believe that the scope exception in ASC 460-10-15-7(k) would apply, as the fixed price would equate to the "guaranteed price" within the scope exception language, though companies should carefully evaluate the terms of the arrangement to determine if there are other conditions of the trade-in. Therefore, in this scenario the trade-in right would

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be outside the scope of ASC 460 and considered a put option that is held by the customer and evaluated under the repurchase guidance in Topic 606 (see Section 9.7.2).

Alternatively, if an entity determines that the trade-in right is a guarantee within the scope of ASC 460, then the entity would measure the trade-in right at fair value and exclude that amount from the transaction price in accordance with the scoping guidance in ASC 606 related to contracts partially in the scope of other topics. The remaining transaction price would be allocated to the performance obligations within the scope of ASC 606 (that is, the sale of the original product). We believe this accounting treatment would be acceptable if conditions of the trade-in right require or are dependent upon the customer entering into a subsequent contract for goods or services.

3.2 Transfers of nonfinancial and in substance nonfinancial assets to counterparties other than customers

An entity may transfer (e.g., sell) nonfinancial assets that are not an output of its ordinary activities to a counterparty that is not a customer. For example, a bakery may sell its used delivery trucks to a dealership that sells used commercial vehicles (i.e., a noncustomer), or a clothing manufacturer may sell its used manufacturing equipment to an equipment restoration business (i.e., a noncustomer). These are transfers of nonfinancial assets to a party other than a customer that would fall within the scope of ASC 610-20. In addition, an entity may transfer to a counterparty that is not a customer an ownership (or variable) interest in a consolidated subsidiary that does not meet the definition of a business or nonprofit activity and for which substantially all of its fair value is concentrated in real estate. This is also the transfer of nonfinancial assets to a party other than a customer that would fall within the scope of ASC 610-20. These are just a few examples of the types of transfers involving nonfinancial assets for which ASC 610-20 is used to recognize any gain or loss resulting from the transfer. In addition, ASC 610-20 introduces the concept of in substance nonfinancial assets and provides guidance on how to account for transfers of such assets to counterparties other than customers. While these types of transfers are not within the scope of ASC 606 (because they are within the scope of ASC 610-20), the accounting model applied to these transfers may result in certain aspects of ASC 606 being used for accounting purposes.

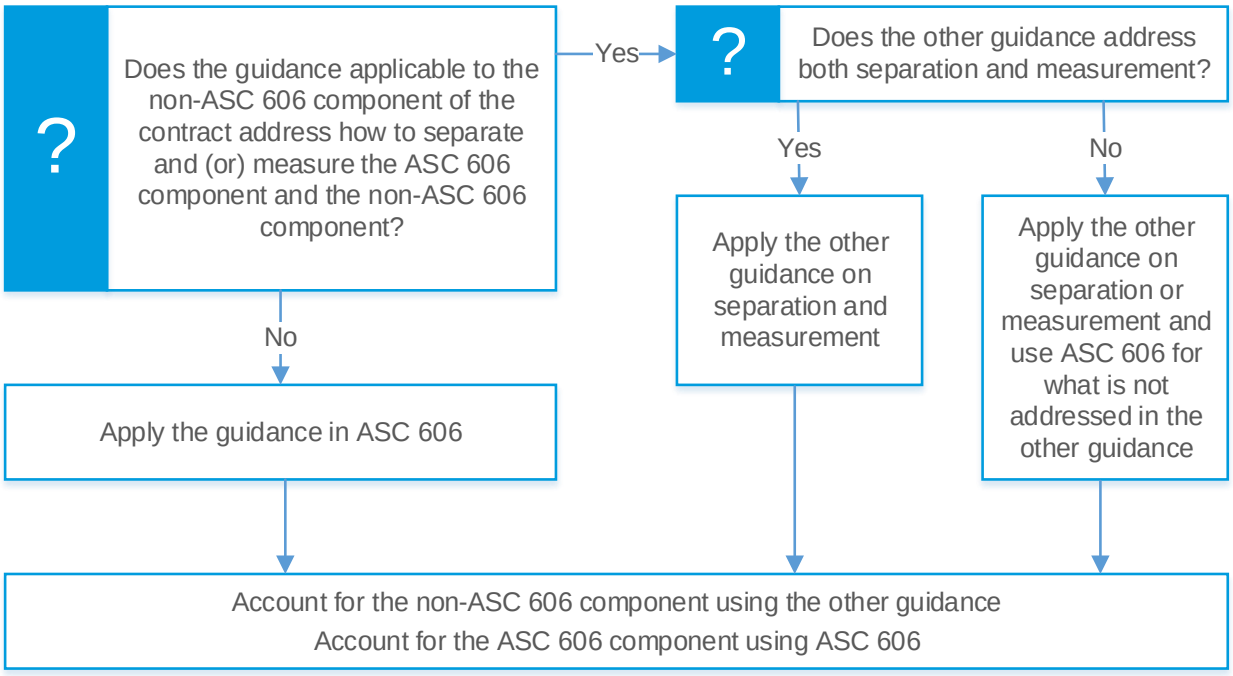
Appendix A provides additional information about the scope of and overall accounting model in ASC 610-20, as well as the presentation and disclosure requirements of ASC 610-20.

3.3 Contracts only partially within the scope of ASC 606

A contract may be partially within the scope of ASC 606 and partially within the scope of other guidance in the ASC. In this situation, the entity is required to separate and measure the component of a contract within the scope of the other guidance in accordance with that guidance. If the other guidance does not state how to separate and (or) measure the component(s) of the contract within the scope of ASC 606 (i.e., the ASC 606 component) and the component(s) of the contract within the scope of the other guidance (non-ASC 606 component), the relevant guidance in ASC 606 is applied. The amount allocated to the non-ASC 606 component of a contract is recognized using the other applicable guidance, and the amount allocated to the ASC 606 component is recognized in accordance with ASC 606.

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The following flowchart captures the decisions involved in identifying the guidance that should be applied to account for a contract partially within the scope of ASC 606.



An example of a contract partially within the scope of ASC 606 is one that includes a guarantee (other than a product or service warranty) within the scope of ASC 460 and other goods and services within the scope of ASC 606. Based on the guidance in ASC 460, the guarantee should be separated from the goods and services and measured at its fair value. The remaining goods and services and consideration in the contract should be accounted for in accordance with ASC 606.

The approach used to identify the guidance that should be applied to account for a contract partially within the scope of ASC 606 is largely consistent with legacy GAAP on multiple-element arrangements.

3.3.1 Contracts that include a contribution component and an exchange transaction component

A not-for-profit entity's contract with a third party may include a component that is an exchange transaction within the scope of ASC 606 and a component that is a contribution within the scope of ASC 958-605. The difference between a contribution and an exchange transaction is discussed in Question 3Q.1.4.

ASC 958-605-55-9 to 55-12 provides guidance specific to membership dues and addresses separating and measuring the component of a membership arrangement within its scope (i.e., the component of the membership that represents an inherent contribution within the scope of ASC 958-605) from the component of a membership arrangement not within its scope (i.e., the component of the membership that represents an exchange transaction within the scope of ASC 606). While this guidance is specific to memberships, paragraph 8.7.05 of the Revenue Recognition AAG indicates that the same guidance should be applied by analogy to other transactions (e.g., grants, awards, naming opportunities, gifts in kind). In addition, paragraph 8.7.06 of the Revenue Recognition AAG indicates that whenever a contract includes an exchange transaction component and a contribution component, those components should be separated and measured using the same approach used to separate and measure the exchange transaction and contribution components of a membership. Because the other guidance in this situation

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addresses both separation and measurement of the ASC 606 and non-ASC 606 components of the contract, that other guidance is used for separation and measurement purposes instead of the separation and measurement guidance in ASC 606. In other words, the component of the contract that is an exchange transaction (ASC 606 component) should be separated from the component that is a contribution (ASC 958-605), measured, allocated and accounted for as follows:

- *Exchange component*. Measure the fair value of the exchange transaction, allocate the lesser of that amount and the resources received from the counterparty (consideration due under the contract, such as membership dues) to the exchange transaction and account for the amount allocated to the exchange transaction in accordance with ASC 606. (Note that if the resources received from the counterparty are less than the fair value of the exchange transaction, there is no contribution component.)
- *Contribution component.* Measure the contribution as the excess of the resources received from the counterparty (consideration due under the contract, such as membership dues) over the fair value of the exchange transaction and account for that amount in accordance with ASC 958-605.

This approach to separating and measuring the ASC 606 and non-ASC 606 components of a contract applies only to how not-for-profit entities separate the exchange transaction and contribution components of a contract and should not be analogized to by other entities or in other situations.

3.3.2 Contracts that include a lease component and a revenue component

Under ASC 842, when a contract includes both a lease component (i.e., the ASC 842 component) and a nonlease component (e.g., the ASC 606 component), the lessor must separate the lease and nonlease components from each other and allocate the contract consideration between the lease and nonlease components using the allocation guidance in ASC 606 (see Section 8.3). For example, maintenance services, which are often included in lease agreements of real estate, are considered separate services and unrelated to the right to use the underlying asset (building) subject to the lease. Therefore, maintenance services are considered a nonlease component under ASC 842 and accounted for in accordance with ASC 606. ASC 842 also includes a practical expedient under which lessors may, in certain circumstances, elect, by class of underlying assets, to not separate nonlease components from the associated lease component, similar to the expedient provided for lessees. The lessor practical expedient is limited to circumstances in which the nonlease component or components otherwise would be accounted for under the new revenue guidance and both (a) the timing and pattern of transfer are the same for the nonlease component(s) and associated lease component and (b) the lease component, if accounted for separately, would be classified as an operating lease. If the nonlease component or components associated with the lease component are the predominant component of the combined component, an entity should account for the combined component in accordance with ASC 606. Otherwise, the entity should account for the combined component as an operating lease in accordance with ASC 842. If a lessor qualifies for and elects the practical expedient, certain disclosures are required.



Example 3-1: Contract that includes a lease component and a revenue component (printers and maintenance)

Company A sells and leases printers and provides related maintenance services. Company A enters into a contract with Customer B for the following:

- Lease of Printer X for three years
- Maintenance of Printer X for three years
- Sale of Printer Y
- Maintenance of Printer Y for three years

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This contract includes a lease component (i.e., the ASC 842 component) and a nonlease component (i.e., the revenue component). The lease component is made up of the lease of Printer X for three years. The nonlease component is made up of the sale of Printer Y and the maintenance of Printer X and Printer Y for three years. Company A has not applied the practical expedient in ASC 842 to combine the lease and nonlease components; therefore Company A must allocate the total payments and consideration under the contract between the lease and nonlease components using their relative standalone selling prices. The lease component is then accounted for using ASC 842, and the nonlease component is accounted for using ASC 606.

If Company A elected the practical expedient in ASC 842, it would account for the lease and maintenance of Printer X as a combined component if the required criteria are met. Assuming the lease of Printer X is the predominant component in the combined component, the combined component would be accounted for as an operating lease under ASC 842.



Example 3-2: Contract that includes a lease component and a revenue component (building space and common area maintenance)

Company A leases building space and provides related common area maintenance services. Company A enters into a contract with Customer B for the following:

- A lease of the fifth floor of Building X for three years
- Customer B's share of common area maintenance (CAM) services for Building X for three years

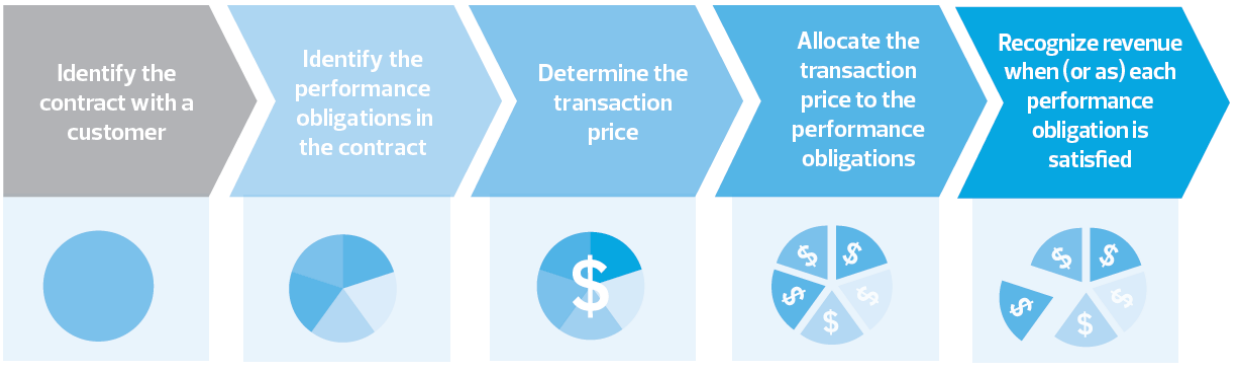
This contract includes a lease component (i.e., the ASC 842 component) and a nonlease component (i.e., the revenue component). The lease component is made up of the lease of the fifth floor of Building X for three years. The nonlease component is made up of the CAM services. Company A has not applied the practical expedient in ASC 842 to combine the lease and nonlease components; therefore Company A must allocate the total payments and consideration under the contract between the lease and nonlease components using their relative standalone selling prices. The lease component is then accounted for using ASC 842, and the nonlease component is accounted for using ASC 606.

If Company A elected the practical expedient provided by ASC 842, it would account for the lease and CAM services as a combined component if the required criteria are met. Assuming the lease of the fifth floor of Building X is the predominant component in the combined component, the combined component would be accounted for as an operating lease under ASC 842.

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4. Core principle and key steps

The core principle underlying the guidance in ASC 606, which is included in ASC 606-10-10-2, 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." ASC 606-10-05-4 sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



An entity should consistently apply the guidance in ASC 606 to similar contracts and in similar situations.

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5. Step 1: Identify the contract with a customer

5.1 Definition of a contract

Because ASC 606 provides guidance on how an entity should account for contracts with its customers, it is important to determine whether a contract exists. A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." An entity's enforceable rights and obligations in a revenue-generating transaction typically include its obligation to transfer specific goods or services to the customer and its right to receive payment for the specific goods or services transferred.

Ensuring that the agreements an entity enters into with its customers meet the definition of a contract requires an entity to have appropriate practices and processes in place and functioning when entering into those contracts. Various factors should be taken into consideration in identifying and establishing those practices and processes, including the following:

- *Whether the entity conducts business in different legal jurisdictions.* If so, the practices and processes the entity has in place to enter into agreements with its customers may need to vary depending on the applicable legal jurisdiction(s). For example, if one of the legal jurisdictions in which the entity does business requires agreements with customers to be in writing, the entity should ensure it has the appropriate practices and processes in place to enter into written agreements with its customers in that legal jurisdiction.
- *Whether the entity conducts business in more than one industry.* If so, the practices and processes the entity has in place to enter into agreements with its customers may need to vary depending on the industry. For example, if entering into oral agreements with customers is the practice in one industry, while entering into written agreements with customers is the practice in another industry, the entity should ensure it has the appropriate practices and processes in place to enter into the appropriate type of agreement within each industry.

By definition, an agreement (whether written, oral or implied based on the entity's usual business practices) must be enforceable for it to be considered a contract. The enforceability of a right or obligation is a legal determination. However, the FASB staff clarified in Question 11 of the FASB RRI Q&As that ASC 606 does not require consultation with legal counsel to determine whether a contract exists in all cases. Rather, the staff believes that in most cases it will be self-evident whether a contract meets Step 1. For those few cases where it is not clear whether a contract exists, additional work may be required, which may or may not require legal assistance, depending on the particular facts and circumstances.

5Q.1.1 Does a contract exist for accounting purposes if an agreement that otherwise meets the definition of a contract provides the unilateral and enforceable right to each party to terminate the agreement with no compensation to the other party if it is wholly unperformed?

No. If both parties to an agreement that otherwise meets the definition of a contract have the unilateral and enforceable right to terminate the agreement without having to compensate the other party when the agreement is wholly unperformed, a contract does not exist for accounting purposes. For this purpose, wholly unperformed means that the entity has not satisfied any part of its performance obligations (i.e., the entity has not transferred any promised goods or services) and the customer has not paid, or is not obligated to pay, any of the related consideration. In this situation, the agreement has no effect on the entity's financial position so long as it remains wholly unperformed. As a result, the agreement is not a contract for accounting purposes. Once the entity or customer performs, a contract exists for accounting purposes and should be evaluated in the context of the contract existence criteria in Section 5.2 to determine whether the remaining steps in the five-step revenue recognition model should be applied to the contract.

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5Q.1.2 How does an entity account for goods or services provided to a customer before it enters into a contract with the customer that meets the contract existence criteria?

As discussed in Section 5.2, a set of contract existence criteria must be met prior to applying the remaining steps in the five-step revenue recognition model. Several of these criteria are based on elements in the definition of a contract (e.g., enforceable rights and obligations). As a result, if the entity has not entered into a contract, all of the contract existence criteria would not be met. If all of the contract existence criteria are not met, no revenue is recognized (even for nonrefundable cash already received by the entity) until either: (a) a contract is entered into, all of the contract existence criteria are met and application of the remaining steps in the five-step revenue recognition model results in recognizing revenue or (b) the entity's circumstances are the same as one of the three circumstances under which revenue is recognized when the contract existence criteria are not met (see Section 5.2.2). Consider the following example.

Example 5-1: Accounting for health care services provided before a contract is entered into with a patient (ASC 606-10-55-102)

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.

RSM COMMENTARY: This example illustrates that a contract does not exist if the entity has not, for whatever reason, determined whether the customer is committed to perform its obligations.

The hospital's continued assessment of the contract is included in Example 5-7.

During the timeframe the entity transfers goods or services to a customer for which it is not able to recognize revenue because it has not yet entered into a contract with the customer that meets the contract existence criteria, the question arises with respect to how the entity should account for the fulfillment costs it incurs to transfer those goods or services when those fulfillment costs do not fall within the scope of specific guidance in the ASC. This issue was addressed in Question 76 of the FASB RRI Q&As, and the FASB staff and TRG concluded that if the fulfillment costs an entity incurs to transfer goods or services to a customer before it has entered into a contract with the customer that meets the contract existence criteria do not fall within the scope of specific guidance in the ASC but do meet the fulfillment cost capitalization criteria in ASC 340-40-25-5 (see Section 13.1.2), such costs should be capitalized. The FASB staff and TRG also discussed the following two questions that arise when an entity transfers goods or services to a customer before it has entered into a contract with the customer that meets the contract existence criteria:

- *How should revenue be recognized once a contract that meets the contract existence criteria is entered into with the customer?* The FASB staff and TRG concluded that revenue should be recognized on a cumulative catch-up basis for performance obligations satisfied over time (see Section 9.3). If the entity uses a cost-based measure of progress toward complete satisfaction of the performance obligation (see Section 9.3.2), it will need to carefully consider which costs have

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essentially been transferred to the customer because only those costs should be included in measuring the entity's progress to date.

- *How should any capitalized fulfillment costs be recognized once a contract that meets the contract existence criteria is entered into with the customer?* The FASB staff and TRG concluded that any capitalized fulfillment costs related to services transferred to a customer when the entity did not have a contract with the customer that met the contract existence criteria should be expensed if they relate to either progress made to date or services already transferred to the customer.

While not explicitly addressed by the FASB staff and TRG, revenue also should be recognized on a cumulative catch-up basis for performance obligations satisfied at a point in time. In other words, if an entity has transferred control of promised goods to a customer before it has entered into a contract with the customer that meets the contract existence criteria, once the entity has entered into such a contract with the customer, it should recognize revenue for those promised goods for which control has previously transferred to the customer.

The following example illustrates accounting for services transferred to a customer before a contract has been entered into with that customer.



Example 5-2: Accounting for services transferred to a customer before a contract has been entered into with the customer, and accounting for the contract once it has been entered into with the customer (TRG 33, paragraph 4)

A manufacturer enters into a long-term contract with a customer to manufacture a highly customised good. The customer issues purchase orders for 30 days of supply on a rolling calendar basis (that is, every 30 days a new purchase order is issued). Purchase orders are non-cancellable and the manufacturer has a contractual right to payment for all work in process for goods once an order is received. The manufacturer will pre-assemble some goods in order to meet the anticipated demand from the customer based on a non-binding forecast provided by the customer. At the time the customer issues a purchase order, the manufacturer has some goods on hand that are completed and others that are partially completed.

The entity has determined that each customised good represents a performance obligation satisfied over time in accordance with paragraph 35(c) [606-10-25-27(c)] because the customized goods have no alternative use and the manufacturer has an enforceable right to payment once it receives the purchase order.



RSM COMMENTARY: Assume the entity charges the customer $10,000 for each highly customized good. Also assume the following:

- The entity receives a purchase order from the customer for 10 highly customized goods.
- The purchase order, together with the long-term contract under which the purchase order was issued, meets the definition of a contract and meets the contract existence criteria.
- At the time the purchase order is received, six of the highly customized goods are complete and the costs capitalized as inventory for these goods is $42,000. In addition, there are four other highly customized goods (7 to 10) in the following stages of completion:
  - Good 7 is 80 percent complete, and the costs capitalized for this good are $5,600.
  - Good 8 is 60 percent complete, and the costs capitalized for this good are $4,200.
  - Good 9 is 40 percent complete, and the costs capitalized for this good are $2,800.
  - Good 10 is 20 percent complete, and the costs capitalized for this good are $1,400.

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- There are no other highly customized goods in process.

Because each of the highly customized goods is its own performance obligation (see Chapter 6) and because control of each of the highly customized goods transfers to the customer over time (see Section 9.3), the entity recognizes the following amounts of revenue and costs on a cumulative catch-up basis on the date it receives the purchase order from the customer for the 10 highly customized goods:

Good	Percent complete	Revenue to be recognized (Percent complete × $10,000 × number of goods)	Costs to be recognized
1 to 6	100%	$60,000	$42,000
7	80%	8,000	5,600
8	60%	6,000	4,200
9	40%	4,000	2,800
10	20%	2,000	1,400
Total to be recognized upon receipt of purchase order		$80,000	$56,000

The entity recognizes the remaining revenue and costs related to the four highly customized goods not complete when it received the purchase order over time as the entity continues to satisfy each of those performance obligations.

5.2 Contract existence criteria

The existence of a contract is not enough in and of itself to require application of the remaining steps in the ASC 606 revenue recognition model to the contract. Only if a contract meets the following contract existence criteria should it be accounted for in accordance with that model:

- *Approvals have been obtained and a commitment to perform exists on the part of both parties.* The form of a contract is not determinative, and as a result an approved contract may be written, oral or implied. When evaluating whether both parties are committed to perform, contract termination rights must be considered as discussed further in Question 5Q.1.1 and Section 5.3.2.
- *Rights of both parties are identifiable.* An entity must be able to identify both parties' rights regarding the promised goods or services in a contract, as otherwise the entity would be unable to determine when control of those goods or services has transferred as discussed further in Chapter 9.
- *Payment terms are identifiable.* Payment terms for the promised goods or services must be identifiable, as otherwise an entity would be unable to determine the transaction price in the contract. These payment terms may be fixed or variable as discussed further in Chapter 7.
- *Commercial substance exists.* For a contract to have commercial substance, the risk, timing or amount of the entity's future cash flows must be expected to change as a result of fulfilling the contract. As noted in paragraph BC40 of ASU 2014-09, one of the reasons this criterion was included was to ensure that entities don't artificially inflate their revenue by transferring goods and services back and forth to one another with little or no cash consideration involved.

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- *Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur).*

These criteria are first evaluated at contract inception and, if all of the criteria are met, they only need to be reassessed if there is a significant change in circumstances. For purposes of assessing whether a change is significant enough to cause a reassessment of the contract existence criteria, an entity should consider the FASB's basis for including those criteria in ASC 606, which is captured in paragraph BC48 of ASU 2014-09: "to filter out contracts that may not be valid and that do not represent genuine transactions, and therefore recognizing revenue for those contracts would not provide a faithful representation of such transactions." A situation in which reassessment was deemed necessary is captured in Chapter 9.

While any reassessment should not result in the reversal of any revenue already recognized, an entity should consider whether any receivables or contract assets recognized before the significant change in circumstances are impaired.



Spotlight on change

In many cases, legacy GAAP required *persuasive evidence of an arrangement* to exist before revenue could be recognized. While there are many similarities between this criterion and ASC 606 requiring there to be enforceable rights and obligations and the contract existence criteria to be met, the legacy GAAP criterion was only met once an entity has evidence of an arrangement that is consistent with its customary business practice in similar situations. For example, if an entity's customary business practice is to evidence arrangements with signed contracts from its customers, a signed contract must be executed before revenue can be recognized under legacy GAAP. However, under ASC 606, the entity in this example is focused on whether there are enforceable rights and obligations and whether the contract existence criteria are met, which do not necessarily require a signed contract. As a result, the lack of a signed contract does not affect the recognition of revenue if there are enforceable rights and obligations and the contract existence criteria have otherwise been met. Entities that evidence arrangements with signed contracts must carefully evaluate the process they currently have in place to determine whether persuasive evidence of an arrangement exists and whether any changes to that process are needed to properly apply ASC 606. For example, the entity whose customary business practice is to evidence arrangements with signed contracts from its customers will need to change its process to focus on when there are enforceable rights and obligations and when the contract existence criteria are met, which may be before a signed contract is executed.

5Q.2.1 Does a Master Service Agreement (MSA) qualify as a contract under ASC 606?

On its own, an MSA typically will not meet the contract existence criteria. However, if the MSA includes minimum quantities that must be purchased over its term, it may meet the contract existence criteria depending on the other facts and circumstances.

5Q.2.2 How do fiscal funding clauses affect whether the contract existence criteria are met?

A fiscal funding clause typically gives a federal government agency the right to terminate a contract if it does not receive the necessary funding through the budgeting and appropriation process. Because of the federal government's budgeting process, it is common for the government to enter into long-term contracts that are only partially funded. In such instances, the entity will first need to evaluate whether a contract exists for both the funded and unfunded portions of the contract. This evaluation may depend on the nature of the goods or services being provided. For example, in a construction or aerospace contract, the entity is likely to determine that the contract existence criteria are met for both the funded and unfunded portions because the federal government would not enter into a contract for a partially built building, ship or airplane, which indicates that the federal government has the ability and intention to pay

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for all the promised goods and services in the contract, including the unfunded portion. As noted in footnote 2 of paragraph 3.1.11 of the Revenue Recognition AAG, this evaluation should consider the likelihood of contract cancellation and if it is determined that cancellation would occur only upon some remote contingency, the contract should be considered noncancellable. If, on the other hand, the entity is providing a monthly service and the contract does not include any terms or conditions that would indicate that the federal government is committed to fund the contract in the future, only the funded portion may qualify as a contract.

5.2.1 Collectibility criterion

To account for a contract in accordance with ASC 606, an entity must be able to conclude that collection of substantially all of the amount to which it will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur). For this purpose, only the customer's ability and intention to pay is considered. In addition, it is important to keep in mind the following about the collectibility assessment:

- The purpose of assessing whether collection is probable is solely to determine whether there is a substantive transaction between the entity and its customer. Once the determination is made that a contract exists for purposes of applying ASC 606, collectibility generally does not affect the subsequent measurement or recognition of revenue except, for example, when a significant financing component exists.
- The collectibility assessment is focused on the customer's ability and intention to pay substantially all, *but not all*, of the consideration to which the entity otherwise expects to be entitled.
- The amount evaluated for collectibility is based on the goods or services that *will be transferred* to the customer, which may not be all of the promised goods or services in the contract.

Before evaluating the likelihood of collection, the entity must determine the amount that should be evaluated for collectibility. To do so, there are two primary considerations:

- *Transaction price.* As discussed in detail in Chapter 7, 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 its customer. An entity considers a number of factors in estimating the transaction price, including: (a) whether the entity intends to offer the customer a price concession and (b) whether the customer has a valid expectation of receiving a price concession based on the entity's customary business practices, published policies or specific statements. In general, the entity does not take the customer's credit risk into consideration when estimating the transaction price except, for example, when the contract includes a significant financing component (which requires use of a discount rate that reflects the customer's credit risk when estimating the transaction price).
- *Ability to mitigate credit risk*. An entity may be able to mitigate its credit risk through its ability to stop transferring promised goods or services upon nonpayment by the customer and its practice of doing so. Taking into consideration the entity's ability to mitigate its credit risk could, depending on the facts and circumstances, result in the amount evaluated for collectibility being an amount less than the transaction price. This is consistent with the focus of the collectibility criterion on the amount the entity expects to be entitled to for the goods or services that *will be transferred* to the customer, which may not be all of the promised goods or services in the contract. Another way an entity may be able to mitigate its credit risk is by requiring its customers to pay in advance. While the entity has mitigated some of its credit risk in this situation, the amount evaluated for collectibility would still include the portion of the transaction price prepaid by the customer. However, collection of at least the amount prepaid would be considered probable if the customer's prepayment is nonrefundable. The right to repossess transferred goods or services should not be considered in assessing the entity's ability to mitigate its credit risk.

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The amount evaluated for collectibility is used only for that purpose. In other words, if the entity arrives at the amount evaluated for collectibility by concluding that the promised goods or services that will be transferred to the customer are less than all of the promised goods or services in the contract, that conclusion does not affect the requirement to consider all of the promised goods or services in the contract when applying the remainder of ASC 606. For example, determining the amount evaluated for collectibility generally has no effect on identifying the performance obligations or determining the transaction price.

A significant amount of judgment must be exercised when determining whether the customer has the ability and intention to pay substantially all of the consideration to which the entity will be entitled in exchange for the promised goods or services that will be transferred to the customer. Making this determination is partly forward looking and requires consideration of all the relevant facts and circumstances, which include contractual terms as well as the entity's customary business practices and knowledge of the customer.

If an entity initially concludes that collection of substantially all of the amount to which it will be entitled in exchange for the goods or services that will be transferred to the customer is probable and there is a subsequent change in circumstances that affects that conclusion, the entity needs to consider the following:

- *Is the change in circumstances significant?* If so, the entity needs to reassess all of the contract existence criteria, including whether the likelihood of collecting substantially all of the amount to which it will be entitled in exchange for the remaining goods or services that will be transferred to the customer is still probable. An example of a significant change in circumstances related to whether collectibility continues to be probable is a significant deterioration in a customer's credit risk and ability to access credit due to the loss of major customers.
- *Does the change in circumstances affect any receivable or contract asset recorded for the contract?* After a receivable (which is an unconditional right to receive consideration) is recognized in conjunction with the accounting for a contract in accordance with ASC 606, the subsequent accounting for that receivable is based on the guidance in ASC 310 and ASC 326-20 (see Section 14.1). Any impairment losses (or credit losses) recognized in accordance with ASC 310 (or ASC 326-20) are presented as an expense and not a reduction of revenue. In addition, any contract asset recognized in conjunction with the accounting for a contract in accordance with ASC 606 should be evaluated for impairment in accordance with ASC 310 (or ASC 326-20).

Provided next are a series of examples illustrating the application of the collectibility criterion.



Example 5-3: Assessing collectibility in a contract to transfer control of a building in exchange for a 5 percent nonrefundable deposit and long-term financing (ASC 606-10-55-95 to 55-98)

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.

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.

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

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).

b. The customer lacks other income or assets that could be used to repay the loan.

c. The customer's liability under the loan is limited because the loan is nonrecourse.

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.



RSM COMMENTARY: Note that the entity's right to repossess the building if the customer does not pay the remaining amounts owed could not be used as a basis for satisfying the collectibility criterion.

The $50,000 nonrefundable deposit paid by the customer to the entity at contract inception is recognized as a liability. The entity only derecognizes the liability and recognizes revenue when: (a) all of the contract existence criteria are met and application of the remaining four steps in the five-step revenue recognition model results in the recognition of revenue or (b) the entity's circumstances are the same as one of the three circumstances under which revenue is recognized when the contract existence criteria are not met (see Section 5.2.2).

A question that may arise in this and similar scenarios is how the entity should account for the building. The FASB acknowledged this question in paragraph BC28 of ASU 2016-12 and indicated the following:

- The concept of what it means to control an asset in Concepts Statement 6 was used for purposes of developing the criteria used in ASC 606 to determine whether control of a promised good or service has transferred to a customer (see Section 9.1).
- An asset (such as the building in this example) should only be derecognized when the entity transfers control of the asset to the customer (i.e., the entity loses control of the asset).
- Derecognition of an asset upon transferring control of the asset to a customer is not dependent on whether revenue related to the sale of that asset to the customer has been recognized.
- There is not enough information provided in the example to determine whether or when control of the building has transferred to the customer.

If additional information were made available with respect to whether and when the entity lost control (or the buyer obtained control) of the building, judgment would need to be exercised in reaching a conclusion about whether and when control of the building transferred to the customer.

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Example 5-4: Assessing collectibility in a contract for services where credit risk may or may not be mitigated by the entity's ability to stop transferring services (ASC 606-10-55-98A to 55-98I)

Case B—Credit Risk Is Mitigated

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.

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.

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.

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.

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.

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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.



RSM COMMENTARY: In Case B, if the entity did not have a business practice of stopping service in response to customer nonpayment, it would not be able to conclude that its credit risk related to substantially all of the consideration to which the entity is entitled for the services the entity will provide for as long as the customer continues to pay for those services has been mitigated. As a result, if the collectibility criterion is not met with respect to that amount, the entity would recognize a liability for any cash received and would only derecognize that liability and recognize revenue when: (a) all of the contract existence criteria are met and application of the remaining four steps in the five-step revenue recognition model results in the recognition of revenue or (b) the entity's circumstances are the same as one of the three circumstances under which revenue is recognized when the contract existence criteria are not met (see Section 5.2.2).



Example 5-5: Assessing collectibility in a contract for services when all payments are advance payments (ASC 606-10-55-98J to 55-98L)

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.

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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).



RSM COMMENTARY: If the entity's customary business practice in this example was to continue providing services to the customer upon nonpayment, credit risk would not be mitigated and the collectibility criterion would not be met.



Example 5-6: Assessing collectibility in a contract for prescription drugs when there is an implicit price concession (ASC 606-10-55-99 to 55-101)

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.

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.

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.



RSM COMMENTARY: Assume that accounting for the contract in accordance with ASC 606 results in the entity recognizing accounts receivable and revenue of $400,000 upon transferring control of the prescription drugs to the customer. If the entity subsequently reduces the receivable by $100,000, it will need to determine whether the entry for the corresponding $100,000 debit is an additional price concession (which would reduce revenue) or an impairment loss under ASC 310 (or credit loss under ASC 326-20). Making this determination would require significant judgment to be exercised and careful consideration of all the facts and circumstances.

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Example 5-7: Assessing collectibility in a contract for health care services when there is an implicit price concession (ASC 606-10-55-103 to 55-105)

[See Example 5-1 for the first part of this example:]

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.

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.

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.



RSM COMMENTARY: The transaction price in this example is $1,000 even if the entity expects to bill and pursue collection of an amount greater than $1,000. For additional information about this example and how to account for situations in which less than $1,000 is collected from the customer, refer to our white paper, Changes to revenue recognition in the health care industry.



Example 5-8: Assessing the effects of a significant change in circumstances related to the collectibility criterion on the accounting for a contract involving a patent license with royalties (ASC 606-10-55-106 to 55-109)

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.

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

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

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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.

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.

5.2.1.1 Assessing collectibility on a portfolio basis

The discussion and examples of assessing collectibility thus far have been focused on assessing the collectibility of a single contract. While such an approach may be feasible in certain situations (such as those involving a manageable volume of unique contracts for large dollar amounts), it may not be feasible in other situations (such as those involving a large volume of homogenous contracts for similar dollar amounts). As discussed in Section 5.4.1, ASC 606 may be applied to a portfolio of similar contracts if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts. In addition, the practical expedient to account for a portfolio of contracts does not have to be applied to all groups of similar contracts. For example, an entity may elect to account for one group of similar contracts as a portfolio of contracts and another group of similar contracts individually.

Electing the practical expedient to account for a portfolio of contracts is not the same as using a portfolio of data to make an estimate for an individual contract. For example, an entity may account for its contracts individually (i.e., not elect the practical expedient), but use a portfolio of historical data for similar contracts to estimate the collectibility of an individual contract. When using a portfolio of historical data to make an estimate for an individual contract, it is important to monitor contracts in that portfolio to ensure they continue to be representative of the individual contract.

The FASB staff and TRG discussed applying the portfolio approach to assess collectibility. This issue was addressed in Question 9 of the FASB RRI Q&As, and the FASB made it clear that when considering collectibility of a portfolio, an entity could conclude that collection is probable for the entire portfolio, even though it anticipated that some unidentified customers would default on their payments, as illustrated in the following example. However, if the expected collection rate for the portfolio is very low, the entity should consider whether it is offering a price concession, or whether the low collection rate indicates that collectibility is not probable for a customer within that class and therefore a contract does not exist.



Example 5-9: Assessing collectibility on a portfolio basis (Question 9 of the FASB RRI Q&As)

An entity has a large volume of homogenous revenue generating customer contracts for which billings are done in arrears on a monthly basis. Before accepting a customer, the entity performs procedures designed to ensure that it is probable that the customer will pay the amounts owed. If these procedures result in the entity concluding that it is not probable that the customer will pay the amounts owed, the entity does not accept them as a customer. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that it will have some customers that will not pay all amounts owed. While the entity collects the entire amount due from the

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vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 98% of the amounts billed.



RSM COMMENTARY: The FASB staff and TRG concluded that the entity in this example should recognize revenue for 100 percent of the amount billed as revenue and then, when required by the guidance in ASC 310 (or ASC 326-20), recognize impairment losses (or credit losses) as an expense for the 2 percent it does not collect. Key factors in arriving at this answer include:

- The entity has a large volume of homogenous revenue-generating contracts.
- The entity's historical evidence of collectibility is representative of its expectations for the future.
- The entity has customer acceptance procedures that result in only providing goods or services to customers for which it is probable that the customers will pay the amounts owed.

Also, while not explicitly stated in the example, the presumption is that the customer acceptance procedures are in place and operating effectively. If that were not the case, a different conclusion would be reached. In addition, to assess collectibility on a portfolio basis, the entity must conclude that doing so will not provide a materially different result compared to assessing collectibility on a contract-by-contract basis. The entity should document its analysis supporting its ability to assess collectibility on a portfolio basis.

5.2.2 Contract existence criteria are not met

In situations in which one or more of the contract existence criteria is not met at contract inception, the entity should reassess the criteria each reporting period (as necessary) to determine whether all of the criteria subsequently are met. At the point in time that all of the criteria are met, the remaining steps in the revenue recognition model in ASC 606 are applied. Until that point in time, the entity recognizes a liability for any consideration received. The nature of that liability depends on the facts and circumstances related to the entity's obligation, which could be to either: (a) transfer goods or services in the future or (b) refund the amount received from the customer. While the contract existence criteria are not met, the entity only derecognizes the liability and recognizes revenue when the amounts paid by the customer are nonrefundable and one of the following is true:

- The entity has no remaining performance obligations and it has received all, or substantially all, of the amounts promised by the customer.
- The contract has been terminated.
- The entity has: (a) transferred control of the goods or services to which the nonrefundable consideration relates and (b) stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services.

These are the only three circumstances under which revenue is recognized when the contract existence criteria are not met.

5.3 Contract term for purposes of applying ASC 606

Determining the term of the contract is important because it will affect application of the remaining steps in the five-step revenue recognition model to the contract. For example, the contract term will affect the promised goods or services (and performance obligations) identified in Step 2 and the transaction price determined in Step 3.

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The contract term is the period of time over which the entity and its customer have present enforceable rights and obligations. Determining this period may be affected by any number of factors, including whether the entity and (or) its customer have termination rights under the contract (see Section 5.3.2).

5.3.1 The effects of contract renewal options on the contract term

As discussed in Section 6.6.1.1, a contract renewal option that can be exercised in the future should be accounted for as a performance obligation if the option provides a material right to the customer that it would not have received without entering into the contract with the entity. In addition, as discussed in Section 6.6.3.2, a contract renewal option that is a performance obligation may only affect the contract term upon its exercise, depending on the facts and circumstances. If the contract renewal option does not provide a material right, it is considered a marketing or promotional offer and not part of the contract. As a result, a contract renewal option does not affect the contract term determined for purposes of applying ASC 606, regardless of whether the option provides a material right.

5.3.2 The effects of contract termination rights on the contract term

At two separate meetings, the FASB staff and TRG discussed how the right to terminate a contract should be taken into consideration in determining the contract term for purposes of applying ASC 606. These issues were addressed in Questions 7 and 8 of the FASB RRI Q&As; this section includes a summary of the conclusions reached by the FASB staff and TRG.

The legally enforceable contract period should be considered the contract term for purposes of applying ASC 606. Whether the legally enforceable contract period should include the period subject to an enforceable termination right depends on whether exercising that right results in a substantive termination penalty or other substantive required payment:

- If so, the period subject to the enforceable termination right should be included in the contract term.
- If not, the period subject to the enforceable termination right should not be included in the contract term.

For purposes of making this determination:

- It does not matter whether the contract has a stated contract term.
- The enforceable termination right could belong to just the entity, just the customer or both the entity and the customer.
- A substantive required payment other than a termination penalty is a fee (e.g., a partial bonus related to the entity's performance prior to termination) that: (a) the customer would not otherwise have to pay until the contract term ends and (b) is based on conditions that might have changed during the remainder of the contract term.
- A substantive required payment other than a termination penalty does not include amounts owed to the entity for goods or services already transferred to the customer in accordance with the contract.
- An entity's past practice of not enforcing payment of a termination penalty could legally restrict (e.g., render unenforceable) its right to that termination penalty. Determining whether this is the case may depend on the legal jurisdictions involved and may require consultation with legal experts.

To the extent there is a termination penalty or other required payment upon termination of the contract that is not substantive, the termination right essentially represents a contract renewal right and should be evaluated as such (see Section 6.6.1.1). In other words, while the nonsubstantive termination penalty does not affect the determination of the contract term for purposes of applying ASC 606, it may result in the identification of an additional performance obligation, depending on the facts and circumstances.

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Provided next are examples that illustrate the effects of termination rights and penalties on determining the contract term for purposes of applying ASC 606.



Example 5-10: Determining the contract term when termination rights exist

The following table provides a summary of a series of examples included in Question 7 of the FASB RRI Q&As which illustrate how the right to terminate a contract affects the contract term for purposes of applying ASC 606.

Stated contract term	Termination rights (Note 1)	Substantive termination penalty or other substantive required payment upon termination	Termination penalty or other required payment upon termination is enforced	The contract term for purposes of applying ASC 606
None (The entity continues providing services until the contract is terminated.)	Both the entity and the customer may terminate the contract at any time.	No	Not applicable	Does not extend beyond goods or services already provided
Two years	Both the entity and the customer may terminate the contract after the first 15 months elapse.	No	Not applicable	15 months
Two years	Both the entity and the customer may terminate the contract at any time.	The party exercising its termination right would pay a penalty.	Yes	Two years
Five years	Both the entity and the customer may terminate the contract at any time after the first two years of the contract elapse.	If the customer terminates the contract, it must make a pro rata bonus payment, the whole of which would otherwise be: (a) based on conditions that could change over the remaining contract term and (b) payable at the end of the five-year contract term.	Yes	Five years

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Stated contract term	Termination rights (Note 1)	Substantive termination penalty or other substantive required payment upon termination	Termination penalty or other required payment upon termination is enforced	The contract term for purposes of applying ASC 606
Two years	Both the entity and the customer may terminate the contract at any time.	The party exercising its termination right would pay a penalty.	Yes, if the contract is terminated in the first year of the contract. No, if the contract is terminated in the second year of the contract.	One year, if the entity's past practice of not enforcing the termination penalty in the second year of the contract legally restricts the enforceable rights and obligations under the contract. Two years, if the entity's past practice of not enforcing the termination penalty in the second year of the contract does not legally restrict the enforceable rights and obligations under the contract.

Note 1: While the series of examples in Question 7 of the FASB RRI Q&As all involve both the entity and the customer having the right to terminate the contract, Question 8 indicates that the conclusions would not change if only the entity or only the customer had the right to terminate the contract.



Example 5-11: Determining the contract term in a four-year service contract that includes a customer termination right and penalty (Question 8 of the FASB RRI Q&As)

Contract 1:

Entity A enters into a four year service contract with Customer X with a right to cancel the contract at the end of each year. Contract 1 requires Customer X to pay an annual fee of CU 100, which is the standalone selling price for renewals after Year 3. Customer X can terminate the contract before Year 4 without cause but would incur a termination penalty. The penalty decreases annually throughout the contract term. Assume the penalty is substantive in each period. The following table illustrates the payments under the contract.

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	Year 1	Year 2	Year 3	Year 4
Annual Fee	$100	$100	$100	$100
Termination Penalty	30	20	10	-
Cumulative Fee if Customer Cancels in this Year	$130	$220	$310	$400

In this example, Contract 1 is a four-year contract. That is, the purchases in Years 2-4 are not options for the customer to purchase additional goods or services. The substantive termination penalty is evidence of enforceable rights and obligations throughout the contract term. The termination penalty is ignored until the contract is terminated at which point it will be accounted for as a modification.



RSM COMMENTARY: There is no termination penalty in the fourth year of the contract because the contract can only be terminated at the end of each year. However, if the customer does not terminate the contract at the end of the third year, it must pay $100 for the fourth year of the contract, even if it no longer wants the services. This is conceptually similar to a termination penalty. As a result, the contract term is four years. If the facts were such that the customer could terminate the contract without cause at any time, the contract term would be three years because there is not a substantive termination penalty in Year 4.

5Q.3.1 How should fixed-price contracts with terms governed by Federal Acquisition Regulations be evaluated when determining the contract term?

Contracts with the U.S. federal government ("government") are generally governed by the terms in the Federal Acquisition Regulations (FAR). FAR allows the government to terminate a contract at any point in time for convenience. Given the unusual nature of this type of termination clause outside of arrangements with the government, entities need to evaluate the impact of this clause on the contract term.

As discussed previously in this section, the legally enforceable contract period should be considered the contract term. Whether the legally enforceable contract period should include the period subject to an enforceable termination right depends on whether exercising that right results in a substantive termination penalty. Since the government under FAR can terminate a contract at any time for convenience, determining the term of the contract depends on whether this clause gives rise to a substantive termination penalty.

FAR Subpart 49.2 addresses the general principles for determining the settlement amounts for fixed-price contracts terminated for convenience. On termination of a contract for convenience by the government, FAR stipulates that the entity should be compensated fairly for both the work performed and preparations for the terminated portions of the contract. This would include compensation for the costs incurred on work performed and costs incurred for the terminated portions of the contract, including costs that may not otherwise have been incurred without termination, plus a reasonable profit allowance.

The significance of the expected settlement amounts based on FAR may vary depending on the specific goods or services being provided, which will impact the determination of whether a substantive termination penalty exists. This will need to be evaluated for each specific contract or contract type with the government. If a substantive termination penalty is deemed to exist, then the contract term will be the stated contract term without consideration of this termination right. Otherwise, since the contract can be cancelled by the government at any time, the contract term would be considered day-to-day.

5.4 Combining contracts

While ASC 606 generally applies to individual contracts, criteria are provided to assess whether individual contracts with the same customer (or parties related to the customer) that are entered into at or near the

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same time should be combined for accounting purposes. If one or more of the following criteria are met, individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time are combined for accounting purposes:

- The contracts were negotiated as a package and share the same commercial objective.
- The consideration to be paid under one contract is tied to the other contract's price or performance.
- Some or all of the goods or services in one contract and some or all of the goods or services in the other contract(s) represent a single performance obligation (i.e., some or all of the goods or services in each contract are not distinct from each other).

When a contract is referred to in this guide, it could mean a standalone contract or two or more contracts combined based on the preceding guidance.

5.4.1 Accounting for contracts on a portfolio basis

ASC 606 may be applied to a portfolio of similar contracts if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts. ASC 606 does not include specific guidance to consider when evaluating whether contracts are similar, so significant judgment may need to be applied. Some items to consider when evaluating the similarity of contracts include whether the contracts have similar general terms and conditions, duration, customer type or class, and performance obligations.

If an entity elects this practical expedient, any estimates or judgments it makes in applying ASC 606 to the portfolio of contracts should reflect the portfolio's size and composition. In addition, while the entity should have support for why accounting for a portfolio of contracts is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts, paragraph BC69 of ASU 2014-09 indicates that it was not the FASB's intent for each outcome to be quantitatively evaluated.

5.5 Contract modifications

Contract modifications occur when the entity and its customer agree to add or change enforceable rights and obligations in the contract (e.g., changes to the contract's scope and [or] price). The decision to add or change the contract's enforceable rights and obligations may be a normal part of the entity's relationship with its customer, or the decision may result from a dispute between the parties. While in some cases it will be clear that the enforceable rights and obligations in the contract have been changed and agreed to by the entity and its customer, in other cases it may not be so clear. In those cases where it is not clear, the entity should ensure it has considered all the relevant facts and circumstances (including its customary business practices) and then carefully exercise its judgment to determine whether the rights and obligations in the contract have changed and whether those changes are enforceable (which may require consultation with legal experts). Understanding whether the changes are enforceable is important because changes that are not enforceable do not give rise to changes in the accounting for the contract.

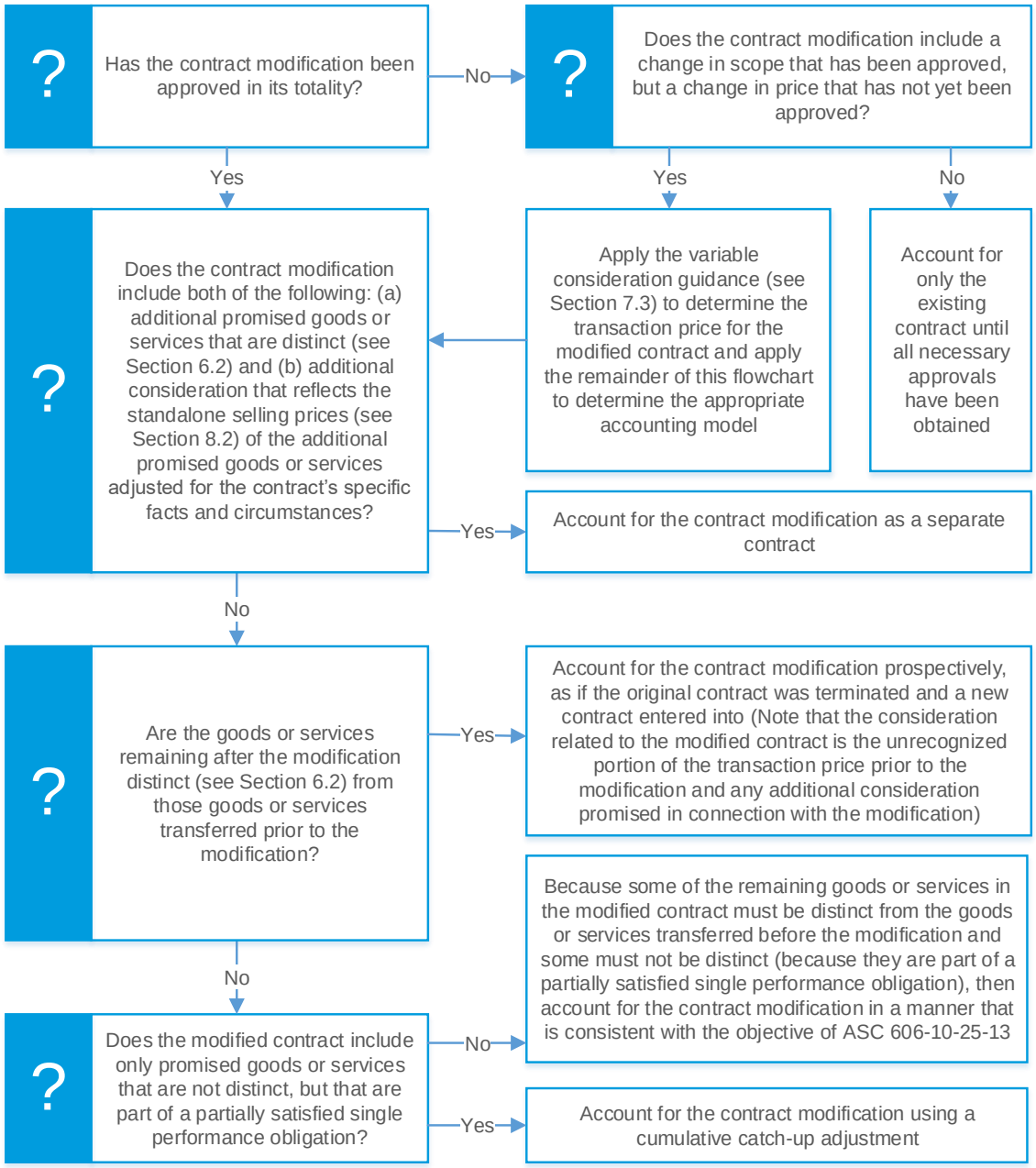
Modifications can arise for a multitude or reasons, but particular attention should be given to modifications negotiated as a result of a significant change in the circumstances of the customer to determine whether the contract existence criteria should be reassessed. For example, a significant deterioration in a customer's credit risk and ability to access credit due to the loss of major customers would trigger reassessment of the contract existence criteria as it draws into question whether the collectibility criterion continues to be met.

In general, contract modifications must be properly approved by both parties before the entity accounts for the modification. The approvals of a modification may be oral, in writing or implied based on the entity's customary business practices. If a contract modification includes changes to both the scope and price of the contract, and the scope changes have been properly approved, but the price changes have

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not yet been properly approved, the entity applies the variable consideration guidance in ASC 606 (see Section 7.3) to determine the transaction price for the modified contract and accounts for the modification using the appropriate model.

The accounting model applied to a contract modification under ASC 606 depends on a number of factors, including the pricing of the modification, whether any new products or services added by the modification are distinct and whether any of the remaining goods or services are part of a partially satisfied single performance obligation. As shown in the following flowchart, depending on the facts and circumstances, a contract modification could be accounted for as: (a) a separate contract, (b) the termination of one contract and execution of a new contract (which results in prospective treatment) or (c) part of the original contract (which could result in the recognition of a cumulative catch-up adjustment).



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Spotlight on change

The general revenue recognition guidance in legacy GAAP did not comprehensively address how to account for contract modifications. As a result, the accounting policies entities have historically applied under legacy GAAP to account for contract modifications needed to change to reflect the comprehensive model to account for contract modifications in ASC 606. In addition, while the revenue recognition guidance in legacy GAAP for construction-type and production-type contracts addressed how to account for various types of contract modifications (including change orders and claims), this guidance was significantly different from the model for contract modifications in ASC 606. As a result, entities that follow legacy GAAP for construction-type and production-type contracts also needed to change their accounting for contract modifications upon the adoption of ASC 606.

Provided next is a series of examples illustrating the application of the contract modification guidance in ASC 606.



Example 5-12: Accounting for a contract modification in which the customer agrees to buy an increased volume of products (ASC 606-10-55-111 to 55-116)

An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case A—Additional Products for a Price That Reflects the Standalone Selling Price

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.

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.

Case B—Additional Products for a Price That Does Not Reflect the Standalone Selling Price

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.

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

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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.

Consequently, the amount recognized as revenue for each of the remaining products is a blended price of $93.33 {[($100 × 60 products not yet transferred under the original contract) + ($80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.



RSM COMMENTARY: To identify the appropriate accounting model to apply to a contract modification, an entity must determine whether any additional products or services added by the modification are priced at their standalone selling prices. As illustrated in Case A, this determination is made based on the standalone selling price of the products as of the date of the contract modification and not the date of the original contract.

In Case B, the pricing of the contract modification includes the following two pricing reductions (which are treated separately for accounting purposes in the example): (a) a credit related to the original contract for the initial 60 products transferred with minor defects and (b) a discount off the price to be paid for an additional 30 products to be transferred as a result of the modified contract. The solution in Case B recognizes the credit related to the original contract as a revenue reduction when it is granted to the customer.

If an entity encounters a situation similar to the one in Case B in which two pricing reductions are being provided as part of a contract modification—one related to past performance issues under the original contract and one related to the additional goods or services to be transferred under a modification to that contract—the entity should carefully consider all of the facts and circumstances and exercise sound judgment in determining whether application of the guidance in ASC 606 should result in the entity: (a) using the approach used in Case B or (b) assuming termination of one contract and execution of a new contract (i.e., the modification accounting model that would result). If the latter approach had been appropriate in Case B, the $900 customer credit would not have been recognized as a revenue reduction upon the contract modification date. Instead, the remaining consideration expected under the modified contract of $7,500 [($100 × 60 products) + ($50 × 30 products)] would have been recognized as the 90 products under the modified contract were transferred. In other words, as control of each of those products was transferred, the entity would have recognized $83.33 ($7,500 ÷ 90 products) as revenue.



Example 5-13: Accounting for a contract modification when there is variable consideration attributable to products transferred prior to the modification (ASC 606-10-55-117 to 55-124)

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.

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.

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When Product X transfers to the customer at contract inception, the entity recognizes revenue of $600.

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.

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.

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RSM COMMENTARY: On November 30, 20X0, the transaction price for the modified contract of $900 is allocated equally to the performance obligation for Product Y and the performance obligation for Product Z because Products Y and Z have the same standalone selling prices.

This example illustrates that even though a contract modification is accounted for as if the original contract was terminated and a new contract entered into, if the transaction price for the original contract included estimated variable consideration and there is subsequently a change in that estimate, some of that change may be attributable to the goods or services transferred prior to the contract modification (i.e., the hypothetically terminated contract), depending on the facts and circumstances.



Example 5-14: Accounting for a contract modification that increases the term of a services contract and reduces the price per year (ASC 606-10-55-125 to 55-128)

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.

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).

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.

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 5-15: Accounting for a contract modification in which the promised goods and services in a construction contract are a single performance obligation before and after the modification (ASC 606-10-55-129 to 55-133)

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

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services as a single performance obligation satisfied over time in accordance with paragraph 606-10-25-27(b) because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

Transaction price	$1,000,000
Expected costs	700,000
Expected profit (30%)	$300,000

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.

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress toward complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 percent of its performance obligation on the basis of costs incurred to date ($420,000) relative to total expected costs ($700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, the cumulative revenue and costs recognized for the first year are as follows:

Revenue	$600,000
Costs	420,000
Gross profit	$180,000

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.

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.

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Example 5-16: Accounting for a disputed contract claim involving a change to the contract price (ASC 606-10-55-134 to 55-135)

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.

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.



RSM COMMENTARY: While the entity has incurred costs due to the delay in getting access to the customer-owned land (which ultimately will result in an increase in the transaction price), the incurrence of those costs does not result in the transfer of any of the promised goods or services in the contract, so no revenue should be recognized upon filing the claim with the customer. If the entity uses a cost-based measure of progress toward completion of the contract, it will need to exclude from that measure the costs associated with the delay (see Section 9.3.2).

Because the entity has enforceable rights under the contract related to filing a claim for the costs it incurred related to the delay, it should treat the inclusion of that claim in the transaction price as variable consideration. As a result, it should estimate the amount of the claim using either the most likely amount method or the expected value method (see Section 7.3.2) and then include that estimate in the transaction price to the extent it is probable that doing so will not result in a significant reversal of cumulative revenue recognized upon settlement of the claim.

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6. Step 2: Identify the performance obligations in the contract

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. If a contract has more than one performance obligation, an entity must estimate the standalone selling prices of each performance obligation and allocate the transaction price to each performance obligation using the relative standalone selling price method (Step 4) and determine whether the transaction price allocated to each performance obligation should be recognized over time (and if so, the method of measuring progress toward complete satisfaction of the performance obligation) or at a point in time (and if so, the point in time control of the underlying goods or services transfers to the customer) (Step 5).

The first step in identifying the performance obligations in the contract is to identify all of the promises to provide goods or services in the contract. Once that step is complete, criteria are applied to determine whether the promises to provide goods or services should be treated as performance obligations and accounted for separately.

6.1 Identifying promises to transfer goods or services

Promises to transfer goods or services come in a variety of shapes and sizes and are most often explicitly stated in the contract. ASC 606-10-25-18 provides the following examples of promised goods or services:

> Depending on the contract, promised goods or services may include, but are not limited to, the following:
>
> a. Sale of goods produced by an entity (for example, inventory of a manufacturer)
>
> b. Resale of goods purchased by an entity (for example, merchandise of a retailer)
>
> c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)
>
> d. Performing a contractually agreed-upon task (or tasks) for a customer
>
> e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
>
> f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)
>
> g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
>
> h. Constructing, manufacturing, or developing an asset on behalf of a customer
>
> i. Granting licenses (see paragraphs 606-10-55-54 through 55-60 and paragraphs 606-10-55-62 through 55-65B)
>
> j. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45).

Identifying many of these types of promised goods or services in a contract should be relatively straightforward, such as the sale of inventory by a manufacturer or retailer, the performance of contractually agreed-upon tasks (e.g., cleaning services) by a service provider (e.g., professional cleaner) and the license of IP (e.g., software) by an entity (e.g., software company). However, identifying other types of promised goods or services may not be as straightforward. For example, identifying an option to purchase additional goods or services in the future or a when-and-if-available upgrade right as a promised good or service in a contract may not be as straightforward given the different ways such

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options and rights might be captured in a contract. The key is for an entity to scrutinize its contracts and identify all of the promises to transfer goods or services to the customer.

Consideration also needs to be given to whether there are promises to transfer goods or services that arise out of an entity's customary business practices instead of an explicit contract provision. If an entity's customary business practice, published policy or specific statement creates a valid expectation on the customer's part to receive a good or service from the entity (e.g., training on how to use purchased equipment), an implicit promise to transfer goods or services exists that should be accounted for just like an explicit promise to transfer goods or services. Consider the following examples:



Example 6-1: Identifying the promised goods or services when the contract includes the sale of equipment to a distributor and an implicit promise to provide maintenance services to the end customer (ASC 606-10-55-151 and 55-154 to 55-155)

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

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.

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.



Example 6-2: Identifying the promised goods or services when the contract includes the sale of equipment to a distributor, with the entity later promising maintenance services to the end customer (ASC 606-10-55-151 and 55-156 to 55-157A)

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

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.

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.

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Instead, the obligation to provide maintenance services is accounted for in accordance with Topic 450 on contingencies.

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.



RSM COMMENTARY: The offer to provide maintenance services to the distributor's end customers was not part of the negotiated exchange between the entity and the distributor, either explicitly or implicitly. As a result, the maintenance services did not exist as a promised good or service in the contract. In addition, at the point in time the entity began offering the maintenance services to end customers of the distributor, the contract between the entity and the distributor was complete. As a result, the entity should account for the offer to provide maintenance services to the distributor's end customers by accruing the expected costs associated with providing the maintenance services on the products not yet sold by the distributor to an end customer on the date the offer is made. In addition, the offer to provide maintenance services to the distributor's end customers would not be considered a contract modification. However, if the entity began offering the maintenance services to end customers prior to completion of the contract between the entity and the distributor, the entity would need to consider whether that offer was a modification of the contract.

To the extent sales to the distributor are expected to continue as part of the entity's ongoing relationship with the distributor, the entity will need to evaluate whether there is a performance obligation for maintenance services on future sales to the distributor.

6.1.1 Promised goods or services that are immaterial in the context of the contract

An entity may choose not to identify for further evaluation under ASC 606 those promised goods or services that are immaterial in the context of the contract. However, if the entity chooses not to identify such promised goods or services for further evaluation, the costs related to the goods or services that are immaterial in the context of the contract should be accrued if revenue related to the performance obligation in which those goods or services are included is recognized before those goods or services are transferred to the customer. In addition, an entity should consistently apply this election to contracts with similar promised goods or services in similar circumstances.

The entity's decision to not identify promised goods or services that are immaterial in the context of the contract for further evaluation under ASC 606 does not change the requirements in ASC 606 to evaluate optional goods or services to determine whether they represent a material right to the customer (see Section 6.6).

If an entity elects to treat a promised good or service as immaterial in the context of the contract, it should document the evaluation performed in arriving at a conclusion that the promised good or service is immaterial in the context of the contract. This evaluation should consider whether the promises are either quantitatively or qualitatively material to the customer. In addition, because the guidance indicates that to not be identified for further evaluation under ASC 606 the promised good or service must be immaterial in the context of the contract, the entity is not required to aggregate the promised goods or services that are immaterial in the context of the related contracts for purposes of evaluating whether those promised goods or services are material as a whole to the financial statements.

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Example 6-3: Accounting for promised goods or services that are immaterial in the context of the contract

Company A, a manufacturer of food-processing equipment, sells a large piece of equipment to Customer B for $200,000. The cost of the equipment included in inventory is $150,000. While Company A provides each customer with an owner's manual that includes detailed operating instructions for the equipment, the contract also indicates that Company A will provide Customer B with a four-hour training session on how to operate the equipment within three months of Customer B receiving the equipment. Company A has never sold the training session on its own. The employees who would provide the training also perform maintenance calls to repair the equipment. Company A charges customers $100 per hour for these maintenance services. The fully loaded hourly cost of the employees who provide maintenance services is $75.

In contemplating whether it should elect to treat the four-hour training session as immaterial in the context of the contract, Company A considers the following information:

- The estimated standalone selling price and cost of the four-hour training session are $400 ($100 per hour × 4 hours) and $300 ($75 per hour × 4 hours), respectively.
- The four-hour training session's estimated standalone selling price, cost and margin represent 0.2 percent of the contract price ($400 ÷ $200,000), equipment cost ($300 ÷ $150,000) and equipment margin ($100 ÷ $50,000), respectively.
- While many customers do not schedule the training session because they are able to operate the equipment using the owner's manual, Company B scheduled its training session at contract inception to occur one week after it receives the equipment.

Company A elects to treat the training as immaterial in the context of the contract

Because Company A elects to treat the four-hour training session it includes in the sales contracts for its large equipment as immaterial in the context of the contract, it records the following journal entry when control of the equipment transfers to Customer B, provided there are no impediments to Company A otherwise recognizing revenue under ASC 606:

	Debit	Credit
Accounts receivable	$200,000	
Cost of goods sold	150,300	
Revenue		$200,000
Inventory		150,000
Accrued training costs		300

When the training is provided, Company A would derecognize the accrued training costs.

Company A does not elect to treat the training as immaterial in the context of the contract

Because Company A does not elect to treat the four-hour training session it includes in the sales contracts for its large equipment as immaterial in the context of the contract, it identifies the training session in its contract with Customer B as a promised service. Next, Company A determines whether the equipment and training are distinct from each other. If so, each is considered its own performance obligation and accounted for separately for purposes of applying the remaining steps in the five-step revenue recognition model. Accounting for the equipment and training separately results in Company A recognizing a large portion of the $200,000 transaction price as revenue when it transfers the equipment

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to the customer and the remaining portion of the transaction price as revenue when it transfers the training to the customer, provided there are no impediments to Company A otherwise recognizing revenue under ASC 606.

6.1.2 Shipping and handling activities

An entity that ships promised goods to its customers performs shipping and handling activities when satisfying its performance obligations. The accounting for these activities depends on whether they are performed before or after a customer obtains control of the promised goods. Passage of legal title is one of several indicators an entity should consider in determining when control of promised goods has transferred to the customer. If, after considering all control indicators (discussed in Section 9.1), the entity concludes that control transfers to the customer based on transfer of title, the following guidance applies:

- When promised goods are shipped FOB destination, title to those goods passes to the customer when the goods reach their destination (e.g., the customer's warehouse). In these situations, the shipping and handling activities occur *before* the customer obtains control of those goods. As a result, the shipping and handling activities should be considered fulfillment activities and not a promised service that should be further evaluated under ASC 606.
- When promised goods are shipped FOB shipping point, title to those goods passes to the customer when the shipping company picks up the goods from the shipping point (e.g., the entity's facilities). In these situations, the shipping and handling activities occur *after* the customer obtains control of those goods. As a result, the shipping and handling activities should be considered a promised service and further evaluated under ASC 606. However, the entity may elect an accounting policy under which shipping and handling activities are accounted for as fulfillment activities and not promised services requiring further evaluation under ASC 606. If the entity elects this accounting policy, the costs related to the shipping and handling activities should be accrued when the entity recognizes revenue for the related promised goods. If elected, the accounting policy must be applied consistently to similar transactions. In addition, an entity that elects the accounting policy must provide the accounting policy disclosures required by ASC 235.



Example 6-4: Accounting for shipping and handling activities

Company A sells 1,000 cashmere sweaters to Customer B for $100,000. The contract requires Company A to: (a) ship the sweaters to Customer B using FOB shipping point terms and (b) charge Customer B for the actual shipping costs. Company A's inventory costs for the sweaters is $50,000. Company A determines that it will cost $1,000 to have Carrier C ship the products from Company A's warehouse to Customer B's retail locations.

Company A evaluates when control of the sweaters passes to Customer B and concludes, based on all of the indicators of control transfer in Section 9.1, that control of the sweaters passes to Customer B when Carrier C picks up the sweaters at Company A's warehouse. This means the shipping and handling activities occur after the customer obtains control of the sweaters. As a result, Company A may either: (a) elect the accounting policy to treat the shipping and handling activities as fulfillment costs that do not have to be further evaluated under ASC 606 or (b) account for the shipping and handling activities as promised services that are further evaluated under ASC 606.

For ease of presentation, the following assumptions have been made for purposes of the discussion that follows: (a) Company A does not provide Customer B with a right of return and (b) Company A should recognize the revenue and costs related to the shipping and handling activities as a principal (i.e., gross) (see Chapter 11).

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Company A elects the accounting policy to treat the shipping and handling activities as fulfillment costs

Because Company A elects the accounting policy to treat the shipping and handling activities as fulfillment costs, it records the following journal entry when control of the sweaters transfers to Customer B (which would be upon Carrier C picking up the sweaters at Company A's warehouse, provided there are no impediments to Company A otherwise recognizing revenue under ASC 606):

	Debit	Credit
Accounts receivable	$101,000	
Cost of goods sold (Note 1)	51,000	
Product revenue		$101,000
Inventory		50,000
Accrued shipping costs		1,000

Note 1: Company A's accounting policy is to include shipping and handling costs in cost of goods sold.

When the shipping costs are billed by Carrier C, Company A records the following journal entry:

	Debit	Credit
Accrued shipping costs	$1,000	
Accounts payable		$1,000

Company A must apply the accounting policy consistently to similar transactions and provide the accounting policy disclosures required by ASC 235.

Company A accounts for the shipping and handling activities as promised services

Because Company A accounts for the shipping and handling activities as promised services, it must determine whether the sweaters and shipping and handling activities are distinct from each other. If so, each would be considered its own performance obligation and accounted for separately for purposes of applying the remaining steps in the five-step revenue recognition model. Accounting for the sweaters and shipping and handling activities separately would result in Company A recognizing a large portion of the $101,000 transaction price as revenue when it transfers control of the sweaters to Customer B and the remaining portion of the transaction price as revenue when (or as) control of the shipping and handling activities transfers to Customer B.

Additional shipping practices and contract terms may need to be taken into consideration in determining the effects of shipping terms on the identification of promised goods or services and when control of the promised goods transfers to the customer. For example, consider situations in which an entity ships promised goods using FOB shipping point terms, but either insures the promised goods during shipment or has a practice of replacing promised goods that are lost or stolen while in transit (which may be referred to as synthetic FOB destination). In all situations, including this example, an entity should determine when control of promised goods transfers to a customer by performing a thorough analysis of its facts and circumstances in the context of all five indicators of control transfer, two of which are passage of title and transfer of risk of loss. An entity shipping promised goods using FOB shipping point terms, but either insuring the promised goods during shipment or having a practice of replacing promised goods that are lost or stolen while in transit, results in title to the promised goods transferring to the customer (which would be when the shipping company picks up the goods at the shipping point) before

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the risk of loss associated with the promised goods transfers to the customer (which would be when the customer receives the goods). As a result, determining when control transfers in these situations hinges on the analysis of the three additional indicators of control transfer discussed in Section 9.1. If, based on the analysis of all five indicators of control transfer, the entity concludes that control of the promised goods transfers to the customer at the shipping point, then the insurance or service of replacing promised goods lost or stolen in transit should be treated as a promised service the entity is providing to the customer. Conversely, if the entity concludes that control of the promised goods transfers to the customer upon receipt of the goods by the customer, then the costs associated with the insurance or replacing the promised goods lost or stolen in transit should be treated as a fulfillment cost related to those promised goods.

Alternatively, an entity may use International Commerce Terms (Incoterms) to govern their shipping and handling. For example, a U.S. entity will often use Incoterms when shipping to an international entity. Incoterms are an established set of defined shipping terms that are commonly used for sale and purchase of goods between entities. While Incoterms do not specifically cover transfer of legal title, they cover other attributes that entities should consider when assessing when control of the goods transfers to the customer, such as which party assumes the risk of transport, who is responsible for transportation costs and at what point the risk and transportation costs transfer to the other party. For example, Ex Works , requires the entity to make the goods available for pick up at the entity's premises or another specified location, and then the customer would assume the risk and transportation costs at that point.

6.1.3 Stand-ready obligations

ASC 606-10-25-18(e) lists the following as an example of a promised good or service that could be included in a contract: "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." The customer benefits from a stand-ready obligation in that it obtains assurance that a good or service (or upgrade) will be provided to it when needed or desired. Example 9-11 addresses the accounting for a stand-ready obligation for a health club membership in which the customer has the right to use the health club as and when it wishes. Questions have been raised in practice with respect to whether other types of promises to customers represent stand-ready obligations. This issue was addressed in Question 22 of the FASB RRI Q&As, and the FASB staff identified the following four types of stand-ready obligations, the first three of which were not explicitly addressed as stand-ready obligations in ASC 606:

Type	Nature	Example
A	The entity controls delivery of the good, service or IP that is subject to the stand-ready obligation.	A when-and-if-available software upgrade right, because the entity must complete the upgrade before it can be delivered
B	Neither the entity nor the customer controls delivery of the good, service or IP that is subject to the stand-ready obligation.	Snow removal services on an as-needed basis, because neither the entity nor the customer control when or how much it will snow
C	The customer controls delivery of the good, service or IP that is subject to the stand-ready obligation.	Periodic equipment maintenance that will be provided after the customer reaches specific usage thresholds
D	The entity makes the good, service or IP that is subject to the stand-ready obligation continuously available to the customer.	Annual health club membership

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The FASB staff and TRG concluded that a key question an entity should consider in determining whether a contract includes a stand-ready obligation is whether the type or quantity of services the entity will provide is known (or specified) or unknown (or unspecified). When the type or quantity of services the entity will provide is unknown or unspecified, that is a strong indication that the nature of the promised good or service is a stand-ready obligation. Consider the following examples.



Example 6-5: Determining whether a stand-ready obligation exists

Example	Does a stand-ready obligation exist?
Promise to transfer unspecified software upgrade rights over the contract term (see Question 6Q.1.3.1)	Yes, this is a Type A stand-ready obligation because the entity controls delivery of the upgrade rights and likely does not know the nature or quantity of software upgrades it will be obligated to provide to the customer over the contract term (see Question 6Q.1.3.1).
Promise to transfer a particular upgrade right that is not specified in the contract, but that the customer expects to receive because: (a) the customer is entitled to when-and-if-available software upgrades and (b) the entity made the customer aware of the nearly completed upgrade during the sales process (see Question 6Q.1.3.1)	No, the implicit promise to transfer the specific upgrade right is not a stand-ready obligation; however, it is a promised good or service that should be evaluated to determine whether it is a performance obligation (see Question 6Q.1.3.1).
Promise to provide snow removal services over the contract term	Yes, this is a Type B stand-ready obligation because neither the entity nor the customer controls the timing or extent of the snow removal services the entity will be obligated to provide to the customer over the contract term.
Promise to provide printer repair services over the contract term on an as-needed basis	Yes, this is a Type C stand-ready obligation because the customer (and not the entity) controls when the repair services will be provided during the contract term, resulting in the entity not knowing the specific type or quantity of repair services it will be obligated to provide over the contract term.
Promise to provide regular printer maintenance services (i.e., regular tune ups) every four months over the contract term	No, this is not a stand-ready obligation because the entity knows that it will go to the customer's site every four months to perform regular printer maintenance.
Promise to continuously make the health club available during normal operating hours for the member's use over the membership period	Yes, this is a Type D stand-ready obligation because the entity does not know when or how often the member will use the health club it is obligated to continuously make available to the member over the membership period.
Promise to provide 10 spin classes over a one-year period	No, this is not a stand-ready obligation because the entity knows it is obligated to provide the customer with a defined number of spin classes.

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Promise to provide extended warranty services on an as-needed basis over the contract term	Yes, this is a Type C stand-ready obligation because the customer (and not the entity) controls when the warranty services will be provided during the contract term, resulting in the entity not knowing the nature or extent of the goods or services it will be obligated to provide in remediating the warranty issues that arise over the contract term.

Based on paragraph BC160 of ASU 2014-09, other questions an entity should consider in determining whether a contract includes a stand-ready obligation include the following:

- *Is the nature of the entity's obligation affected by the extent to which the customer calls on the entity to provide goods or services under the contract?* If not, that would indicate that the nature of the entity's obligation is to stand ready. For example, the nature of a stand-ready obligation to provide a member with continuous access to a health club is not affected by whether the customer uses the health club every day or never.
- *Is the customer obligated to pay the entity regardless of whether it uses the services the entity is obligated to provide on an as-needed or as-desired basis?* If so, that would indicate that the nature of the entity's obligation is to stand ready. For example, if a customer is obligated to pay the entity for printer maintenance services even if it never calls upon the entity to provide such services, this would be indicative of a stand-ready obligation.

If one of the promised goods or services in a contract is a stand-ready obligation, the entity would need to evaluate that stand-ready obligation to determine whether it is a performance obligation that should be accounted for separately. Recognizing revenue for a stand-ready obligation that is a performance obligation is discussed in Section 9.6.

6Q.1.3.1 What is the significance of determining whether an upgrade right is specified or unspecified, either explicitly or implicitly?

As discussed in Section 6.1, implicit promised goods or services also should be identified by the entity for purposes of applying ASC 606. As a result, if the good or service is explicitly or implicitly *specified*, that good or service should be identified as a promised good or service in the contract in and of itself (rather than as a stand-ready obligation). In addition, if the entity is explicitly or implicitly obligated to stand ready to provide other *unspecified* promised goods or services, a stand-ready obligation exists. For example, a contract that includes a software license may indicate that the customer will be provided with any software upgrades over the contract term if and when those upgrades become available. If at the time the contract is entered into there is an in-process software upgrade that the customer learns about from the entity during the sales process and expects to receive as a result of its right to any when-and-if-available software upgrades, the in-process software upgrade would be considered a specified upgrade right and identified as a promised good or service in the contract in and of itself. In addition, a promised good or service also exists related to any unspecified software upgrades the entity stands ready to provide the customer over the contract term if and when they become available (which is a Type A stand-ready obligation).

6Q.1.3.2 What is the difference between an option to purchase additional goods or services and a stand-ready obligation?

The accounting for options is discussed in detail in Section 6.6. An option represents a performance obligation for accounting purposes if it provides the customer with a material right that the customer would not have received without entering into the contract with the entity. An entity is not obligated to provide

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goods or services under an option until the customer exercises the option, and once the customer exercises the option, the nature of the entity's obligation changes. In contrast, an entity is obligated to provide goods or services under a stand-ready obligation without the customer exercising an option, and the nature of the entity's obligation does not change as it performs under its stand-ready obligation.

For purposes of illustrating the difference between an option for additional goods or services and a stand-ready obligation, consider the following example in Question 23 of the FASB RRI Q&As:

> **Example 7 - Supply Agreement:** Supplier enters into a 5-year exclusive master supply agreement with a customer which obligates the supplier to produce and sell parts for a particular product the customer manufactures to the customer as requested. The customer is not obligated to purchase any parts, however, it is highly likely it will purchase parts because the part is required to manufacture the product and it is not practical to get parts from multiple suppliers. Each part is a distinct good that transfers to the customer at a point in time.

As discussed in Example 6-18, the FASB staff and TRG concluded that the promise in this example is an option and should be evaluated as such under ASC 606. Based on the discussion in Section 6.6.1 related to determining whether a contract includes a customer option for additional goods or services, if the entity in this example was obligated to deliver 500 parts over the term of the master supply agreement, the promise would not be an option because the entity is obligated to deliver 500 parts without the customer taking any action other than to tell the entity when to ship one or more parts. Instead, the promise would be to deliver 500 parts.

Determining whether a contract has an option or a stand-ready obligation will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

6.1.4 Activities that are not promised goods or services

Some activities performed by the entity, such as setup activities, do not transfer a good or service to the customer. Instead, those activities are necessary for the entity to fulfill the contract and do not themselves represent a good or service transferred to the customer. As a result, they cannot represent a performance obligation for which revenue is recognized. However, depending on the facts and circumstances, the entity may be required to capitalize the costs to perform these activities under ASC 340-40 (see Section 13.1). Consider the following example and Example 7-13, Example 9-9 and Example 10-5.



Example 6-6: Determining whether certain activities transfer promised goods or services

Company A enters into a contract with Customer B to provide transaction processing services over a five-year period. Before providing the services, Company A must setup Customer B on its systems, which involves: (a) building an interface between its systems and Customer B's systems and testing that interface, (b) migrating and testing Customer B's data and (c) building and testing a portal that Customer B will use to easily access information about the transactions processed and resolve any errors identified in the process. Company A is entitled to a nonrefundable upfront fee of $1 million as compensation for the costs it will incur performing the setup activities and annual transaction processing fees of $3 million.

Building and testing the interface and portal and migrating and testing data are activities Company A performs to enable it to provide transaction processing services to Customer B. These setup activities do not provide any benefit to Customer B absent Company A providing the transaction processing services. As a result, the setup activities do not provide Customer B with a promised good or service, which also means they cannot be a performance obligation. This conclusion is unaffected by the presence of a $1 million nonrefundable upfront fee meant to compensate Company A for the performance of the setup activities. In other words, setup activities do not represent a promised good or service even if a customer pays a nonrefundable upfront fee to compensate the entity for performing those activities.

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Accounting for nonrefundable upfront fees is discussed in Section 7.1.2. Accounting for the setup costs is discussed in Chapter 13.

6Q.1.4.1 Should either of the following guarantees or promises be considered promised goods or services in and of themselves: (a) the entity has a valid patent related to the promised goods or services in the contract or (b) the entity will defend the patent against unauthorized use?

No. Such guarantees and promises are not promised goods or services in and of themselves for purposes of applying ASC 606 and do not affect whether revenue should be recognized over time or at a point in time (see Section 9.2).

6Q.1.4.2 Should exclusivity provisions be considered promised goods or services in a contract with a customer?

Exclusivity provisions are generally not considered promised goods or services and therefore do not represent a separate performance obligation in a contract with a customer. Exclusivity provisions include terms that restrict the entity's (or the customer's) ability to sell (source) goods or services to (from) other entities. The FASB observed in paragraph BC412(b) of ASU 2014-09 that in the context of a license of IP, an exclusivity provision represents an attribute of the license (for example, it delineates the scope of the rights the customer is receiving in relation to the IP). Consistent with this observation, exclusivity provisions should be considered an attribute of the promised good or service rather than a separate distinct promise, which may have an effect on total transaction price, but should not affect the identification of performance obligations or the timing of revenue recognition.

There may be circumstances in which either the entity or the customer makes payments to the other party related to the exclusivity provision in the contract. When a customer makes an upfront payment to the entity related to an exclusivity arrangement, that payment should be evaluated to determine whether it provides the customer with a material right (see Section 6.6). When an entity makes a payment to a customer, that payment should be evaluated in accordance with the guidance on consideration paid or payable to a customer (see Section 7.5).

6.1.5 Practical expedient for private company franchisors (ASU 2021-02)

A franchise agreement generally stipulates that the franchisor will be paid an initial franchise fee in a lump sum in exchange for establishing a franchise relationship, along with the provision of varying levels of pre-opening support, such as training or site selection. When implementing ASC 606, private-company franchisors expressed concerns about the level of effort required to account for initial franchise fees due to the complexity in determining whether pre-opening activities include any separate performance obligations.

To address these concerns, in January 2021 the FASB issued ASU 2021-02, which provides a practical expedient in ASC 952-606-25-2 that permits a franchisor that is not a public business entity that enters into a franchise agreement to account for the following pre-opening services provided to a franchisee as distinct from the franchise license:

- Assistance in the selection of a site
- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural and engineering services, and lease negotiation
- Training of the franchisee's personnel or the franchisee
- Preparation and distribution of manuals and similar material concerning operations, administration and record keeping

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- Bookkeeping, information technology and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate and other taxes or about regulations affecting the franchisee's business
- Inspection, testing, and other quality control programs

If a franchisor elects to use the practical expedient in ASC 952-606-25-2, it is required to disclose that fact. Also, if a franchisor elects this practical expedient, it must apply the guidance in ASC 606-10-25-19 through 25-22 to determine whether the pre-opening services are distinct from one another, unless it makes an accounting policy election to account for the pre-opening services as a single performance obligation. A franchisor that makes this accounting policy election must disclose that fact.

If a franchisor elects not to apply the practical expedient in ASC 952-606-25-2 or if the services performed are not included in the list in ASC 952-606-25-2, the franchisor is required to apply the ASC 606 guidance on identifying performance obligations.

6.2 Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and treated separately for accounting purposes. The determining factor in this analysis is whether each promised good or service is distinct. If a promised good or service meets both of the following criteria, it is considered distinct and accounted for separately as a performance obligation unless the series exception applies (see Section 6.3):

- *Capable of being distinct*. If a customer can benefit from the promised good or service on its own or by combining it with other resources readily available to the customer, the good or service is capable of being distinct.
- *Distinct within the context of the contract.* If the promised good or service is separately identifiable from other promised goods or services in the contract, it is distinct within the context of the contract.

The evaluation of whether a promised good or service is distinct should be performed at contract inception for each promised good or service in the contract.

6.2.1 Capable of being distinct

A promised good or service is capable of being distinct when the entity regularly sells that good or service separately or when the customer could generate an economic benefit from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. The ability to sell the good or service for scrap value only would not, in and of itself, support a conclusion that the promised good or service is capable of being distinct. For a resource to be readily available to the customer, it must be sold separately either by the entity or another party or it must be a good or service that the customer already has obtained as a result of either a contract with the entity (including the contract under evaluation) or another transaction or event. For example, assume an entity sells: (a) a piece of complex food-processing equipment with no alternative use to the customer other than to sell it for no more than its scrap value and (b) services to install the equipment in the customer's unique manufacturing environment. If the entity is the only party that can install the equipment and the entity never sells the equipment without the installation services, the equipment is not capable of being distinct because the customer cannot benefit from the equipment on its own or by combining it with other resources readily available to it. Consider Example 6-7 to Example 6-13.

This criterion should be evaluated based solely on the characteristics of the goods or services without regard to any contractual requirements that may exist relating to the purchase of multiple goods or services together or how the customer plans to use the goods or services. See Case D of Example 6-10, which illustrates the evaluation of the impact of contractual requirements.

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6.2.2 Distinct within the context of the contract

To determine whether a promised good or service is distinct within the context of the contract, the entity must ascertain which of the following best describes its promise within the context of the specific contract:

- *The promise in the contract is to transfer the promised good or service individually.* If this best describes the entity's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
- *The promise in the contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the entity's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* distinct within the context of the contract:

- Is the entity providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services? Another way to think of this question is can the entity satisfy each of the promises in the contract independent of its efforts to satisfy the other promises.

When evaluating whether promises are distinct in the context of the contract, entities should not just consider whether the nature of one of the goods or services causes it to depend on the other good or service in the contract. Rather, the focus should be on whether the goods and services significantly affect one another. Consider the patent application software example discussed by Sarah N. Esquivel, an Associate Chief Accountant in the SEC's Office of the Chief Accountant, at the 2018 AICPA Conference on Current SEC and PCAOB Developments. The company in question provides its customers with software to prepare patent applications, which can be printed and submitted by mail. It also includes a free one-time service of submitting the application electronically. While the electronic submission service depends upon the software, it is offered as a convenience to the customer but does not significantly impact the utility of the software. As a result, the SEC staff noted that the software and the electronic submission service should not be considered highly interdependent or highly interrelated and should be considered distinct in the context of the contract. Conversely, Sheri L. York, a professional accounting fellow in the SEC's Office of the Chief Accountant, provided an example fact pattern at the 2018 AICPA Conference on Current SEC and PCAOB Developments in which the staff did not object to a registrant's conclusion that the nature of its promise was to transfer a combined item—a "smart" commercial security solution—to which each piece of equipment (including the control panel), the technology platform and installation are inputs. In this example, the various promises do significantly affect one another as supported by the fact that the delivery of a "smart" security monitoring service would not be possible if the equipment were not integrated with the technology platform.

To appreciate the effects these indicators can have on determining whether a promised good or service is distinct within the context of the contract, consider the following examples.

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Example 6-7: Identifying the promised goods or services and performance obligations in a contract to build a hospital (ASC 606-10-55-137 to 55-140)

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.

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.

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.

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.



RSM COMMENTARY: Whether revenue for the single performance obligation in this example should be recognized over time or at a point in time is addressed in Section 9.2.

The importance of properly identifying the performance obligation(s) in a contract becomes clear when considering how the accounting for the contract would differ if the entity reached an improper conclusion about the performance obligation(s) that should be identified. In this example, reaching an improper conclusion could have resulted in the entity identifying multiple performance obligations (e.g., one for each promised good or service) instead of a single performance obligation. If multiple performance obligations had been improperly identified, the entity would have had to estimate the standalone selling prices of each performance obligation and allocate the transaction price to each performance obligation using the relative standalone selling price method (Step 4) and determine whether the transaction price allocated to each performance obligation should be recognized over time (and if so, the method of measuring progress toward complete satisfaction of the performance obligation) or at a point in time (and if so, the point in time control of the underlying goods or services transfers to the customer) (Step 5). Improperly accounting for the contract in this manner likely would provide very different accounting results compared to properly accounting for the contract as one with a single performance obligation.



Example 6-8: Determining whether software and when-and-if-available updates should be accounted for as one or more performance obligations (ASC 606-10-55-140D to 55-140F)

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,

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the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

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.

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.



RSM COMMENTARY: One of the key facts leading to the conclusion that the software and when-and-if-available updates are not distinct from each other is how critical the updates are to the continued utility of the software. Most when-and-if-available software updates will not be so critical to the continued utility of the software that they are deemed not to be distinct from each other. Example 6-9 illustrates the more common scenario in which software and when-and-if-available software updates are deemed to be distinct from each other. Determining whether when-and-if-available updates and software (or other IP) are distinct will require significant judgment to be exercised and careful consideration of all the facts and circumstances.



Example 6-9: Identifying the performance obligations in a contract for software, unspecified software updates, installation services and technical support (ASC 606-10-55-141 to 55-150)

Case A—Distinct Goods or Services

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.

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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.

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.

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.

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

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.

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

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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.

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.



RSM COMMENTARY: While most software and when-and-if-available software updates will be distinct from each other (as illustrated in this example), there are situations (such as the one illustrated in Example 6-8) in which the software and a when-and-if-available software update may not be distinct from each other because the update is critical to the continued utility of the software. Determining whether when-and-if-available updates and software (or other IP) are distinct will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

In both Case A and Case B of this example, the installation services could be provided by another party. While that fact resulted in the installation services being considered capable of being distinct in both cases, whether a promised good or service is capable of being distinct is only one of the criteria that must be met under ASC 606 to conclude that the promised good or service is distinct. The other criterion is focused on whether the promised good or service is distinct within the context of the contract. An evaluation of this criterion in Case A and Case B resulted in different conclusions, given the nature of the installation services provided in each case:

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Nature of the installation services	
Case A	**Case B**
• Changing the web screen for each type of user (e.g., marketing, inventory management, IT) • Routine • No significant modifications to the software	• Substantial customization to add significant new functionality to enable the software to interface with certain of the customer's other customized software applications

Given the nature of the installation services in each case:

- While installation services are inherently an integration service, the level of integration between the software and installation services is not significant in Case A, while it is significant in Case B.
- While the software and installation services are inherently interdependent or interrelated, it is likely there is not a high degree of interdependence or interrelationship in Case A (because the installation services are routine and do not significantly modify the software), while it is likely there is a high degree of interdependence or interrelationship in Case B (because the installation services convert the software into the functional and integrated software system the customer expects to receive).
- The installation services in Case A do not significantly modify and customize the software, while they do in Case B.

For these reasons, the entity concluded that the installation services in Case A are distinct within the context of the contract, while the entity concluded in Case B that the installation services are not distinct within the context of the contract.



Example 6-10: Identifying the performance obligations in a contract for equipment and installation (ASC 606-10-55-150A to 55-150F)

Case C—Promises Are Separately Identifiable (Installation)

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.

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).

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

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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.

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)

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

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.



RSM COMMENTARY: If the facts were such that the entity is the only party that could perform the installation and the entity never sells the equipment without the installation services, the entity would have to carefully consider how the customer could benefit from the equipment on its own or by combining it with other resources readily available to it for purposes of determining whether the equipment is capable of being distinct. If the customer could sell the equipment on a secondary market for more than scrap value, it is likely that the customer could benefit from the equipment on its own, which means it is likely that the equipment is capable of being distinct. Conversely, if the equipment had no alternative use to the customer (even for resale on a secondary market), the customer could not benefit from the equipment on its own, which means the equipment is not capable of being distinct.

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Example 6-11: Identifying the performance obligations in a contract for equipment and specialized consumables (ASC 606-10-55-150G to 55-150K)

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.

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).

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.

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.

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.



Example 6-12: Identifying the performance obligations in a contract for the sale of equipment to a distributor and maintenance services to the end customer (ASC 606-10-55-151 to 55-153A)

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

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

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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.

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).

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.



Example 6-13: Identifying the performance obligations in a contract for the sale of a product with a warranty and training services (ASC 606-10-55-309 to 55-315)

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.

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

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.

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

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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.

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.

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.

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.

6.3 The series exception

A series of distinct promised goods or services that are substantially the same *should* be considered a single performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of: (a) each of the goods or services otherwise being considered satisfied over time (see Section 9.2) and (b) the entity otherwise having to use the same method of measuring progress toward complete satisfaction of each good or service (see Section 9.3). This exception is commonly referred to as the series exception. Examples of the types of contracts that may, depending on the facts and circumstances, fall under this exception are long-term contracts for hotel management services, transaction processing services and asset management services. Consider the following example and Example 5-14 and Example 7-9.



Example 6-14: Identifying the performance obligations in a contract that includes a series of distinct goods or services related to providing hotel management services (ASC 606-10-55-157B to 55-157E)

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.

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.

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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.

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.



RSM COMMENTARY: Determining whether distinct services are substantially the same is discussed in Question 6Q.3.6.

Unless otherwise noted, the following questions are based on discussions of the FASB staff and TRG about the series exception. This issue was addressed in Questions 18 through 20 of the FASB RRI Q&As.

6Q.3.1 Why did the FASB provide the series exception?

The FASB's basis for providing the series exception is discussed in paragraphs BC113 and BC114 of ASU 2014-09:

> The Boards 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. The Boards decided to include this notion as part of the definition of performance obligation to simplify the application of the model and to promote consistency in the identification of performance obligations in circumstances in which the entity provides the same good or service consecutively over a period of time (for example, a repetitive service arrangement). To be accounted for as a single performance obligation, each of those promised goods or services must be performance obligations satisfied over time in accordance with paragraph 606-10-25-27.
>
> The Boards observed that without this part of the definition, applying the model might present some operational challenges when an entity provides a series of distinct goods or services that are substantially the same. Otherwise, the entity would be required to identify multiple distinct goods or services, allocate the transaction price to each of the resulting performance obligations on a standalone selling price basis, and then recognize revenue when those performance obligations are satisfied. For example, in a repetitive service contract such as a cleaning contract, transaction

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processing, or a contract to deliver electricity, an entity would be required to allocate the overall consideration to each increment of service (for example, each hour of cleaning) to be provided in the contract. The Boards decided that it would not be cost effective to apply the model in this manner and determined that including paragraph 606-10-25-14(b) as part of the definition of the performance obligation would alleviate costs. This is because when paragraph 606-10-25-14(b) applies (that is, the contract includes a promise to transfer a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer), an entity will identify a single performance obligation and allocate the transaction price to the performance obligation. The entity will then recognize revenue by applying single measure of progress to that performance obligation.

6Q.3.2 Is application of the series exception optional?

No. If a series of distinct goods or services exists, the entity must evaluate whether the series meets the criteria to be accounted for as a single performance obligation. If so, the series of distinct goods or services must be accounted for as such.

6Q.3.3 Why is it important to know whether a single performance obligation is made up of promised goods or services that are not distinct vs. distinct promised goods or services that fall under the series exception?

The accounting for a single performance obligation made up of multiple promised goods or services that are distinct (i.e., a single performance obligation resulting from application of the series exception) differs from the accounting for a single performance obligation made up of multiple promised goods or services that are not distinct in the following ways:

- *Allocation of variable consideration (see Section 8.3.2 and Section 8.3.2.1)*. As illustrated in Example 6-14 and Example 8-8, in certain situations, variable consideration may be allocated in its totality to one performance obligation or a distinct promised good or service in a single performance obligation resulting from application of the series exception. As a result, variable consideration should be allocated, under certain circumstances, to a distinct promised good or service in a single performance obligation made up of multiple distinct promised goods or services, while variable consideration cannot be allocated to a promised good or service in a single performance obligation made up of multiple promised goods or services that are not distinct.
- *Contract modifications (see Section 5.5)*. One of the decision points in accounting for a contract modification requires consideration of whether the goods or services remaining after the modification are distinct from those goods or services transferred prior to the modification. As a result, the accounting model applied to the modification of a contract that has a single performance obligation made up of distinct promised goods or services would be different from the accounting model applied to the modification of a contract that has a single performance obligation made up of multiple promised goods or services that are not distinct.
- *Changes in the transaction price (see Section 8.4)*. In general, a change in the transaction price is allocated to the performance obligations in a contract in the same way the transaction price was allocated at contract inception. However, in limited circumstances, the change may be allocated to one performance obligation or a distinct promised good or service in a single performance obligation resulting from the series exception. One of those limited circumstances is when there is a change in the transaction price due to a change in the estimated variable consideration included therein. This type of change in the transaction price cannot be allocated to a promised good or service in a single performance obligation made up of multiple promised goods or services that are not distinct, but should be allocated, under certain circumstances, to a distinct promised good or service in a single performance obligation made up of multiple distinct promised goods or services (see Example 7-9).

In addition, an entity is required to disclose the amount of the transaction price allocated to unsatisfied and partially satisfied performance obligations (which is part of what is commonly referred to as the remaining performance obligation disclosure). The transaction price for this purpose should include

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variable consideration as otherwise required by ASC 606. However, there is a variable consideration exception to the remaining performance obligation disclosure that allows an entity to exclude variable consideration from the transaction price when the variable consideration has been allocated in its entirety to either: (a) a wholly unsatisfied performance obligation or (b) a wholly unsatisfied promise to provide a distinct good or service in a single performance obligation made up of distinct goods or services (because of the series exception). A single performance obligation made up of promised goods or services that are not distinct only benefits from the variable consideration exception to the remaining performance obligation disclosure if the single performance obligation is wholly unsatisfied. Conversely, a single performance obligation made up of distinct promised goods or services (because of the series exception) benefits from the variable consideration exception to the remaining performance obligation disclosure when: (a) the single performance obligation is wholly unsatisfied or (b) the single performance obligation is only partially satisfied, but the remaining distinct goods or services therein are wholly unsatisfied.

Given the accounting and disclosure implications, it is important for an entity to distinguish between a single performance obligation made up of promised goods or services that are not distinct and a single performance obligation made up of promised goods or services that are distinct (i.e., a single performance obligation resulting from application of the series exception).

6Q.3.4 To apply the series exception, do the distinct goods or services have to be transferred consecutively?

No. The FASB staff and TRG concluded that the goods or services do not have to be transferred consecutively for the series exception to apply. Consider the following example.



Example 6-15: Impact of performance conditions that affect an award's quantity on recognition of compensation cost over an explicit service period

Example A: 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.

Example B: Assume the same facts as the example above, except that different from Example A, the entity does not plan to perform evenly over the 2-year service period. That is, the entity does not produce 1,000 units a month, continuously. Instead, the entity plans to perform the manufacturing service over the 2-year period, but in achieving the production targets, the entity produces 2,000 units in some months and zero units in other months.

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The FASB staff and TRG concluded that the series exception applies in both Examples A and B.



RSM COMMENTARY: This example illustrates that the series of promised goods or services do not have to be provided consecutively for the series exception to apply. In addition, this example illustrates that a single performance obligation resulting from application of the series exception should not always result in ratable recognition of revenue. In Example B, ratable recognition of revenue will not result because of the nonconsecutive nature of the entity's performance, which will be reflected in how the entity measures its progress toward complete satisfaction of the performance obligation.

6Q.3.5 To apply the series exception, must the results of its application be the same as what the results would have been if it had not been applied?

No. The FASB staff and TRG concluded that application of the series exception is not predicated upon arriving at the same accounting result as not applying the series exception.

6Q.3.6 For purposes of determining whether the series exception should be applied, how does an entity decide whether a series of promised services are substantially the same?

The FASB staff and TRG discussed how to determine whether a series of promised services are substantially the same. This issue was addressed in Question 18 of the FASB RRI Q&As. The remainder of this answer is based on the conclusions reached by the FASB staff and TRG.

The first step to answering this question is understanding the nature of the entity's promise to the customer. The nature of the entity's promise when it is providing a series of promised services may be to either: (a) provide a single service for a period of time or stand ready to provide a single service for a period of time (which is typically the case when the quantity of activities the entity will perform over the period of time is unspecified) or (b) provide a specified quantity of services or stand ready to provide a specified quantity of services.

When the nature of the entity's promise is to provide a single service for a period of time or to stand ready to provide a single service for a period of time, the entity should likely focus on whether each time increment of the single service is distinct and substantially the same. Consider Example 6-14, in which the entity concludes it is providing a single service of hotel management services and that each daily increment of hotel management services is distinct from previous or subsequent daily increments of such services. In this example, even though the nature of the individual activities performed each day may be different (e.g., the activities could consist of some combination of cleaning services, reservation services and property maintenance services), the nature of the entity's overall promise is to provide hotel management services on that day. For this reason, the conclusion was reached that each distinct daily increment of hotel management services was substantially the same.

When the nature of the entity's promise is to provide a specified quantity of services or stand ready to provide a specified quantity of services, the entity should focus on whether each service (rather than any time increment) is distinct and substantially the same. Consider a change in the facts of Example 6-14 such that the quantity of hotel management services to be provided by the entity was specified instead of unspecified. For example, assume the entity promises to provide a specific number of hours of cleaning services, reservation services and property maintenance services. In this situation, while the entity likely would conclude that each type of service is distinct, it could not conclude that the different types of services are substantially the same. As a result, the series exception could not be applied to the distinct service types, and instead, each service type likely would be considered its own performance obligation.

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6.4 Accounting consequences

If a promised good or service is distinct, it is considered a performance obligation and accounted for separately unless the series exception (see Section 6.3) applies. A contract having more than one performance obligation results in the entity estimating the standalone selling prices of each performance obligation and allocating the transaction price to each performance obligation using the relative standalone selling price method (Step 4) and determining whether the transaction price allocated to each performance obligation should be recognized over time (and if so, the method of measuring progress toward complete satisfaction of the performance obligation) or at a point in time (and if so, the point in time control of the underlying goods or services transfers to the customer) (Step 5).

If a promised good or service is not distinct, it is combined with other promised goods or services until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the contract.



Spotlight on change

In legacy GAAP, there was a general multiple-element arrangement model, as well as models that focused on specific industries (e.g., software, construction). The criteria used to determine whether an element was treated separately for accounting purposes under these models was different from the criteria in ASC 606. For example, under the general multiple-element arrangement model in legacy GAAP, a delivered element must have standalone value to the customer to be accounted for separately. If the element is sold separately by the entity or another party, it was considered to have standalone value to the customer. The analysis of whether a promised good or service is distinct under ASC 606 requires consideration of more factors than just whether the promised good or service is sold separately. This difference between legacy GAAP and ASC 606 could lead to the identification of different units of account for revenue recognition purposes (e.g., goods and services accounted for separately under ASC 605-25 may need to be bundled together under ASC 606).

6.4.1 Accounting for a portfolio of performance obligations

ASC 606 may be applied to a portfolio of similar performance obligations across multiple contracts for accounting purposes if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the performance obligations. If an entity elects this practical expedient, any estimates or judgments it makes in applying ASC 606 to the portfolio of performance obligations should reflect the portfolio's size and composition. In addition, the entity should have support for why accounting for a portfolio of performance obligations is not reasonably expected to result in materially different outcomes compared to individually accounting for the performance obligations.

6.5 Warranties

The key accounting question for a warranty is whether it represents or includes a performance obligation (i.e., a distinct service). If a warranty represents or includes a performance obligation, part of the transaction price is allocated to the warranty and recognized as revenue as control of the warranty services is transferred to the customer. If a warranty does not represent or include a performance obligation, no part of the transaction price is allocated to the warranty, and instead, it is accounted for in accordance with the product warranty guidance included in ASC 460, which requires accrual of expected warranty costs.

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If the customer has the option to purchase the warranty, it represents a performance obligation and is accounted for separately. If such an option does not exist, the entity must determine whether it is providing: (a) only a warranty that the product complies with agreed-upon specifications (i.e., an assurance-type warranty) or (b) a service (e.g., maintenance) in addition to the assurance-type warranty (i.e., a service-type warranty). Some of the factors an entity should consider in determining whether it is providing a service-type warranty in addition to an assurance-type warranty include the following:

- A warranty required by law is indicative of an assurance-type warranty.
- The longer the warranty is in effect, the more likely it is that the warranty includes a service-type warranty.
- If the entity has to perform certain steps to provide assurance that agreed-upon specifications are met, those steps are likely not performance obligations.

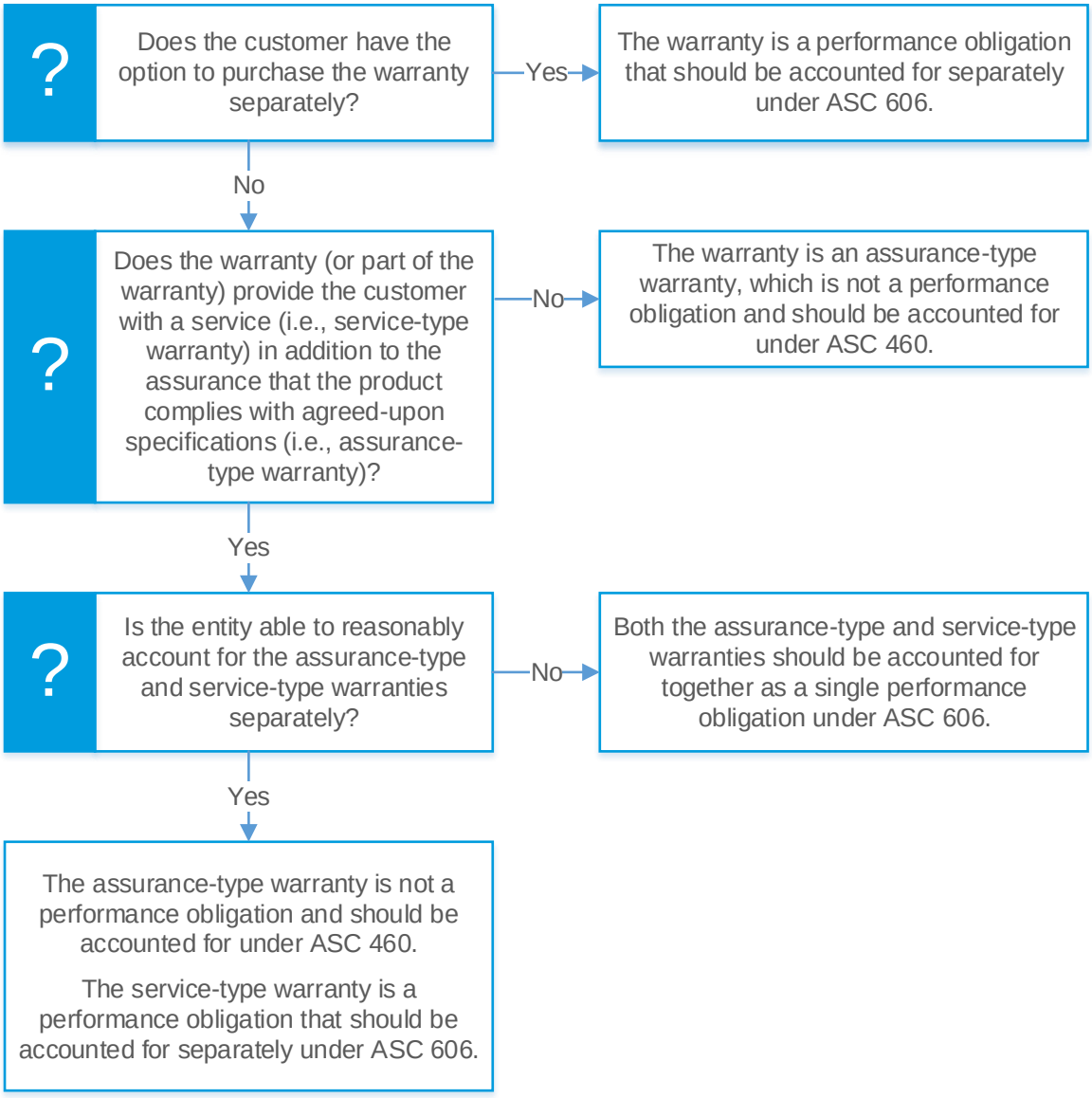
In many cases, determining whether an entity is providing a service-type warranty in addition to an assurance-type warranty will be clear. However, making this determination in other cases may not be as clear, and as a result, will require the exercise of significant judgment and careful consideration of all the facts and circumstances.

If the warranty goes beyond the promise that the product complies with agreed-upon specifications, the entity must determine whether it can reasonably account for the promise that the product complies with agreed-upon specifications (i.e., the assurance-type warranty) separate from the promise that goes beyond the assurance-type warranty (i.e., the service-type warranty). If the entity can reasonably account for the two warranties separate from each other, the assurance-type warranty is accounted for under ASC 460 and the service-type warranty is accounted for as a performance obligation under ASC 606. If the entity cannot reasonably account for the two warranties separate from each other, both warranties are accounted for together as a single performance obligation under ASC 606.

Section 12.2 provides guidance on the recognition of loss provisions on separately priced extended warranty and product maintenance contracts. A service-type warranty that is separately priced falls within the scope of this guidance.

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The following flowchart illustrates the considerations involved in accounting for a warranty included in a contract.



6Q.5.1 Does a performance obligation result from a law requiring the entity to pay compensation for damages or harm caused by one of its products?

No. A performance obligation does not result from a law requiring the entity to pay compensation for damages or harm caused by one of its products. The potential losses under such a law should be accounted for and disclosed in accordance with ASC 450-20.

6Q.5.2 Can a performance obligation result from the entity indemnifying a customer for liabilities or damages that result from claims against the entity for infringement on another entity's legally protected IP (e.g., copyright)?

No. A performance obligation does not result from the entity indemnifying a customer for liabilities or damages that result from claims against the entity for infringement on another entity's patent, copyright,

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trademark or other legally protected IP. The potential losses that could result from providing such an indemnification should be accounted for and disclosed in accordance with ASC 450-20.



Example 6-16: Accounting for the sale of a vehicle with an assurance-type warranty and a service-type warranty included

Company A manufactures multifunction vehicles (MFV). When a customer buys an MFV from Company A, they receive a two-year warranty that provides assurance that the MFV complies with its stated specifications and two years of regular maintenance services. The regular maintenance services involve bringing in the MFV four times a year for what is essentially a tune up. The warranty is always included in the purchase of an MFV. The pricing for the MFV reflects the warranty (i.e., there is no separate charge for the warranty). Company A also provides regular maintenance services to customers after the two years of regular maintenance services it provides with the warranty on a customers' purchase of an MFV. In these situations, Company A charges $500 for each regular maintenance service visit if the customer brings the MFV in for service four times a year. Company A sells an MFV to Customer B for $50,000. The inventory cost of the MFV is $30,000.

Company A provides both an assurance-type warranty (i.e., the two-year warranty that the MFV complies with its stated specifications) and a service-type warranty (i.e., two years of regular maintenance services) with Customer B's purchase of the MFV. Based on the detailed information Company A has about warranty claims and maintenance services provided to customers that have purchased MFVs in the past, Company A concludes that it can reasonably account for the assurance-type and service-type warranties separately. Based on Company A's historical warranty claims data, it expects to incur assurance-type warranty costs of $700 over the two-year warranty period. Based on the guidance in ASC 606 about estimating standalone selling prices (see Section 8.2) and the company-specific and competitor information available to Company A, it estimates the standalone selling price of the MFV to be $48,000. In addition, Company A estimates the standalone selling price of the service-type warranty to be $4,000, which is based on the amount Company A charges for regular maintenance service visits after two years ($500 per visit) and the eight such visits to which Customer B is entitled over two years (four visits each year). Based on this information, Company A allocates the transaction price of $50,000 to the MFV and service-type warranty as follows:

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($50,000) to each PO
MFV	$48,000	92%	$46,000
Service-type warranty	$4,000	8%	4,000
Total	$52,000	100%	$50,000

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When control of the MFV transfers to Customer B, Company A records the following journal entry, provided there are no impediments to Company A otherwise recognizing revenue under ASC 606:

	Debit	Credit
Cash	$50,000	
Cost of goods sold	30,000	
Warranty costs	700	
Product revenue		$46,000
Inventory		30,000
Warranty liability		700
Contract liability		4,000

As Company A transfers the maintenance services to Customer B over the two-year service period, it would recognize revenue and reduce the contract liability.

If Company A's facts and circumstances were different such that they were not able to reasonably account for the warranty (i.e., assurance-type warranty) and maintenance services (i.e., service-type warranty) separately, it would have had to account for them as a single performance obligation and estimate the standalone selling price of that single performance obligation. The expectation would be that the standalone selling price for that single performance obligation would be higher than the standalone selling price for just the maintenance services. All other things being equal, this would result in: (a) less of the transaction price being allocated to the MFV, (b) less revenue being recognized upon Company A transferring control of the MFV to Customer B and (c) a higher beginning balance for the contract liability.



Spotlight on change

While there are many similarities in the accounting for warranties under legacy GAAP and ASC 606, ASC 606 provides more structure around determining whether a warranty should be accounted for separately as a performance obligation. This structure, including the guidance related to assessing whether the warranty provides the customer with a service that goes beyond the promise that the product complies with agreed-upon specifications, could result in changes to how an entity accounts for its warranties.

6.6 Customer options for additional goods or services

As part of a contract, the entity may provide the customer with options for additional goods or services, such as the following: (a) an option to purchase additional goods or services in the future at a discount, (b) award credits (e.g., points, miles) in customer loyalty programs that can be accumulated and used to obtain additional goods or services in the future or (c) a contract renewal right that can be exercised in the future.

As discussed in more detail later in this section, if an option provides a material right to the customer that the customer would not have received without entering into the contract with the entity, the option itself is the performance obligation. In other words: (a) the goods or services that would be provided to the customer if the option were exercised are not identified as promised goods or services or performance obligations and (b) the transaction price does not include the amounts to which the entity would expect to be entitled in exchange for transferring control of any promised goods or services the customer elects to purchase upon exercising the option.

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6.6.1 Determining whether a contract includes a customer option for additional goods or services

In many cases, determining whether a contract includes a customer option for additional goods or services will be relatively straightforward. However, in other cases, such as those in which the contract has variable attributes, it may not initially be clear whether those variable attributes give rise to an option for additional goods or services or variable consideration.

The FASB staff and TRG discussed whether variable attributes in a contract (e.g., variability in the quantity of goods and services that could be transferred to the customer) should be accounted for as an option, variable consideration or something else (such as a minimum purchase requirement). This issue was addressed in Question 23 of the FASB RRI Q&As. The remainder of the discussion in this section is based on the conclusions reached by the FASB staff and TRG.

Understanding the entity's and the customer's rights and obligations is critical to determining whether the variable attributes in a contract should be accounted for as an option or variable consideration. The following table captures the rights and obligations of the entity and the customer that point to the variable attributes in a contract being either an option or variable consideration for accounting purposes:

Points to variable attributes in a contract being…	
An option	**Variable consideration**
The entity is not obligated to transfer additional promised goods or services unless and until the customer exercises its right to purchase those additional goods or services (see Example 6-17 and Example 6-18).	The entity is obligated to provide the promised goods or services without the customer exercising an incremental right. The action taken by the customer is resolving the uncertainty of how much it will pay (see Example 6-19 and Example 6-20).
The customer becomes obligated to transfer additional consideration to the entity only after it both exercises its right to purchase additional promised goods or services and takes control of those goods or services.	The customer becomes obligated to transfer additional consideration to the entity *after (or as)* it obtains control of the promised goods or services transferred by the entity.
Actions taken by the customer obligate the entity to provide additional promised goods or services.	Actions taken by the customer serve to resolve the uncertainty related to the amount of consideration it is obligated to pay.

While in some situations there will be minimal differences between accounting for the variable attributes in a contract as an option instead of variable consideration (or vice versa), it remains important in those situations to reach the appropriate conclusion, given the disclosure requirements in ASC 606. For example, if the contract includes an option that is accounted for as a performance obligation, the entity would be required to include the option in its disclosure requirements about its performance obligations. Conversely, if the contract includes variable consideration, the entity's disclosures about the transaction price allocated to the remaining performance obligations would be affected (unless the entity is eligible for and elects an available practical expedient).

The following examples illustrate how to determine whether a variable attribute in the contract gives rise to an option, variable consideration or something else.

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Example 6-17: Determining whether the ability to purchase additional call minutes or text messages is an option (and a performance obligation) or variable consideration (ASC 606-10-55-340 to 55-342)

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.

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).

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.



RSM COMMENTARY: In this example, the variability in the additional call minutes and text messages the customer may purchase gives rise to an option and not variable consideration. This is consistent with: (a) the customer only having the right (and not the obligation) to purchase additional call minutes and text messages and (b) the entity not being obligated to transfer any additional call minutes and texts messages until the customer exercises its option. Because the contract includes an option and not variable consideration, the entity does not include any of the additional call minutes or text messages it expects the customer to use when identifying the promised services in the contract or the charges for such expected usage in the transaction price. This is the case even if the entity is virtually certain the customer will exercise its option to use the additional call minutes and text messages and the entity has evidence supporting an estimate of the additional call minutes and text messages the customer will use.

If the additional call minutes and text messages the customer may choose to purchase in any month were priced at a discount to their standalone selling prices and the customer could not get those discounts without having entered into the contract with the entity, the option to purchase those additional call minutes and text messages would be a performance obligation because it would represent a material right that the customer would not have received without entering into the contract with the entity.

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Example 6-18: Determining whether the variability in the quantity of product a customer might purchase is an option or variable consideration (Question 23 of the FASB RRI Q&As)

The FASB staff and TRG concluded the following examples include an option (and not variable consideration):

Example of Optional Purchases: Entity B enters into a contract to provide 100 widgets to Customer Y at CU 10 per widget. Each widget is a distinct good transferred at a point in time. The contract also provides Customer Y the right to purchase additional widgets at the standalone selling price of CU 10 per widget. Therefore, the quantity that may be purchased by Customer Y is variable.

Although the quantity that may be purchased is variable, the transaction price for the existing contract is fixed at CU 1,000. That is, the transaction price includes only the consideration for the 100 widgets specified in the contract and any exercise of an option is accounted for as an independent contract (because there is no material right given the pricing of the option to acquire additional widgets in this contract). The contract provides a right that allows the customer to choose the number of additional widgets which are distinct goods. In addition, while Entity B may have an obligation to stand ready to deliver additional widgets, Entity B is not legally obligated to provide the widgets until Customer Y exercises the option.

Supply Agreement: Supplier enters into a 5-year exclusive master supply agreement with a customer which obligates the supplier to produce and sell parts for a particular product the customer manufactures to the customer as requested. The customer is not obligated to purchase any parts, however, it is highly likely it will purchase parts because the part is required to manufacture the product and it is not practical to get parts from multiple suppliers. Each part is a distinct good that transfers to the customer at a point in time.



RSM COMMENTARY: In both examples, the variability in the quantity of widgets or parts the customer may buy should be accounted for as options because the entity is not obligated to transfer (and the customer is not obligated to pay for) the widgets or parts until the customer exercises its option (and the entity transfers control of the widgets or parts to the customer).

In the widget example, the option does not provide a material right to the customer that it would not have obtained without entering into the contract because the widgets that can be purchased by the customer under the option are priced at their standalone selling price. As a result, the option represents a marketing offer that is not accounted for until the option is exercised.

In the parts example, more information would be needed to determine the accounting for the option, including the price at which the customer can buy the parts on an as-needed basis and the standalone selling price of the option.



Example 6-19: Determining whether the variable attribute in a contract gives rise to an option or variable consideration (Question 23 of the FASB RRI Q&As)

The FASB staff and TRG concluded the following two examples include variable consideration (and not options) [Note: these examples represent a selection taken from a larger series]:

Example 3 – Goods: Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges the customer based

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upon usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. The customer is not contractually obligated to use the equipment; however, Entity A is contractually obligated to transfer the equipment to Customer X.

The usage of the equipment by the customer is a variable quantity that affects the amount of consideration owed to the entity. It does not affect the entity's performance obligation, which is to transfer the piece of equipment. In other words, the vendor has previously performed by transferring the distinct good, and the customer's actions that result in additional payment occur after the goods have been transferred and do not require the vendor to provide additional goods or services.

Example 4 – Services: D, a nightclub, hires Company S to provide security services, which includes checking identification of each customer at the door and collecting the entrance fee on the behalf of D. S receives CU 1 for each customer that comes through the door. That is, S will get paid CU 1 each time it checks identification and collects the cover charge. If no customers come into D, then S will not get paid, but it is still obligated to perform each night.

The performance obligation in the contract is the security service for a night. The variability in the contract that affects the amount S is paid does not affect the amount of services to be provided. That is, S is required to perform by watching the door regardless of the number of customers. The events that result in payment occur as S performs the service and are not a result of a choice made by the customer. The amount S ultimately is paid is factored into the measurement of the transaction price.



RSM COMMENTARY: In Example 3, the entity is obligated to transfer control of the equipment to the customer. The customer does not have an option to buy the equipment; it has committed to buying the equipment. The entity has no further obligations to the customer beyond transferring control of the equipment. The customer does not have an option to buy additional goods or services from the entity. The customer's obligation to pay the entity arises after it obtains control of the equipment (i.e., as it uses the equipment). The action taken by the customer is using the equipment (not exercising an option to buy additional goods or services), which is resolving the uncertainty related to the amount of consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how much the equipment is used gives rise to variable consideration (and not an option).

In Example 4, the entity is obligated to transfer security services to the customer. The customer does not have an option to buy these services; it has committed to buying the services. The entity has no further obligations to the customer beyond transferring control of the security services. The customer does not have an option to buy other or additional goods or services from the entity. The customer's obligation to pay the entity arises as it obtains control of the security services (i.e., as patrons visit the customer's nightclub). The action taken by the customer is allowing patrons into its nightclub (not exercising an option to buy additional security services), which is resolving the uncertainty related to the amount of consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how many patrons the customer allows into its night club gives rise to variable consideration (and not an option).

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Example 6-20: Determining whether the variable attribute in a contract gives rise to an option or variable consideration (Part 2) (Question 23 of the FASB RRI Q&As)

The FASB staff and TRG concluded the following two examples include single performance obligations and variable consideration (and not options):

IT Outsourcing: IT Seller and IT Buyer execute a 10-year IT outsourcing arrangement in which IT Seller provides continuous delivery of different outsourced activities over the contract term. For example, the vendor will provide server capacity and manage the customer's software portfolio, along with other activities. The total monthly invoice is calculated based on different units consumed. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported. Price per unit differs for each type of activity provided. IT Seller charges the IT Buyer a non-refundable upfront fee related to the transition activities.

Transaction Processing: Transaction Processer (TP) enters into a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known and is outside the control of the TP and its customer. TP concludes that the customer simultaneously receives and consumes the benefit of providing the network as it performs. TP charges the customer on a per transaction basis. TP also charges the customer a fixed upfront fee at contract inception.



RSM COMMENTARY: The conclusions reached in these examples are directly tied to the FASB staff's conclusions that a single performance obligation exists in each example. If different conclusions were reached about the nature and number of performance obligations present in the example, different conclusions may be reached about how to account for the variable attributes of the contracts.

In the IT outsourcing example, the entity is obligated to transfer continuous integrated IT services to the customer. The customer does not have an option to buy these IT services; it has committed to buying the services. The entity has no additional obligations to the customer beyond transferring control of the IT services. The customer does not have an option to buy any other goods or services from the entity. The customer's obligation to pay the entity arises as it obtains control of the IT services (i.e., as it utilizes the services). The action taken by the customer is utilizing the IT services (not exercising an option to buy additional services), which is resolving the uncertainty related to the amount of consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how much the customer will utilize the IT services gives rise to variable consideration (and not an option). For discussion related to the accounting for the transition (e.g., setup) activities and upfront nonrefundable fee, see Section 6.1.4 and Section 7.1.2, respectively.

In the transaction processing example, the entity is obligated to transfer continuous transaction processing services to the customer. The customer does not have an option to buy these services; it is committed to buying the services. The entity has no additional obligations to the customer beyond transferring control of the transaction processing services. The customer does not have an option to buy any other goods or services from the entity. The customer's obligation to pay the entity arises as it obtains control of the transaction processing services (i.e., as it sends transactions to the entity for processing). The action taken by the customer is utilizing the transaction processing services it is committed to buy (not exercising an option to buy additional services), which is resolving the uncertainty related to the amount of

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consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how much the customer will utilize the transaction processing services gives rise to variable consideration (and not an option). For discussion related to the accounting for the upfront nonrefundable fee, see Section 7.1.2.



Example 6-21: Determining whether an option is actually a minimum purchase requirement (Question 8 of the FASB RRI Q&As)

Contract 2: An entity sells equipment and consumable parts for the equipment (both the equipment and parts are distinct goods that do not meet the overtime criteria). The standalone selling price of the equipment and parts is CU 10,000 and CU100, respectively.

The entity sells the equipment for CU 6,000 (a 40% discount from standalone selling price) and provides an option to purchase each part for CU 100. If the customer does not purchase at least 200 parts, it is required to pay a penalty to repay some or all of the CU 4,000 discount provided on the equipment. The penalty decreases as each part is purchased at a rate of CU 20 per part. A discount of CU 10 would be viewed as a material right to the customer.

In this example, the penalty (or foregoing the upfront discount) is substantive and in effect creates a minimum purchase obligation such that the entity would conclude that the minimum number of parts required to avoid the penalty would be evidence of enforceable rights and obligations. As a result, the contract includes both the equipment and the minimum parts (200) required to not incur the penalty. Therefore, the transaction price is CU 26,000 [(200 × 100) + 6,000], which should be allocated to the multiple performance obligations (CU 8,667 [26,000 * (10,000/30,000)] to the equipment and CU 17,333 [26,000 * (20,000/30,000)] to the parts [86.67 per part]). The entity would account for the failure to purchase additional parts and the resulting penalty as a contract modification.



RSM COMMENTARY: As discussed in Section 5.3.2, a substantive termination penalty results in the contract term including the period subject to the termination right. Similarly, a substantive penalty that implicitly creates a minimum purchase requirement results in the promised goods or services identified in the contract and the transaction price including the minimum number of promised goods or services that must be purchased to avoid the penalty.

While the option to buy the first 200 parts is accounted for as a minimum purchase obligation, the option to buy more than 200 parts does not provide the customer with a material right because those parts would be sold to the customer at their standalone selling prices. As a result, it is considered a marketing offer that is not accounted for until the customer exercises the option to buy more than 200 parts.

6Q.6.1.1 Should volume discounts be accounted for as a customer option for additional goods or services or variable consideration?

It depends. Entities may provide customers with discounts on products or services based on the cumulative volume of purchases made. These volume discounts may apply to either the price of optional purchases that may occur in the future ("prospective") or to previous purchases ("retrospective"), once certain purchase volume is reached. The accounting treatment for these volume discounts depends on whether they apply on a prospective or retrospective basis. If the volume discounts apply to prospective purchases, they would be considered an option for additional goods or services that would be evaluated to determine whether the option provides a material right to the customer and hence is considered a

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performance obligation as discussed in Section 6.6.2. If the volume discounts apply on a retrospective basis, they would be accounted for as variable consideration because it is uncertain whether the entity will have to provide the discount until the customer either does or does not reach the specified volume of purchases. See Section 7.3.7 for further discussion of retrospective volume discounts.

6.6.1.1 Contract renewal and contract termination rights

A contract renewal right is an option that should be evaluated under ASC 606 to determine whether it provides the customer with a material right that should be accounted for as a performance obligation. Depending on the facts and circumstances, contract termination rights may provide an entity with what is essentially a contract renewal right that also should be evaluated under ASC 606 to determine whether it provides the customer with a material right that should be accounted for as a performance obligation.

As discussed in Section 5.3.2, the contract term for purposes of ASC 606 should include the period subject to an enforceable termination right if exercising that right results in a substantive termination penalty or other substantive required payment. When a termination penalty or other required payment upon termination of the contract is not substantive (or is nonexistent), the period subject to the enforceable termination right is not included in the contract term for purposes of ASC 606. Instead, the entity should evaluate the contract as one with a contract renewal right. In essence, requiring no or a nonsubstantive termination penalty or other required payment upon exercising a termination right turns that termination right into a renewal right for accounting purposes.

Consider a situation in which an entity enters into a three-year contract that provides the customer with the option to terminate the contract after two years without having to pay any termination penalty. This situation is economically the same as the entity entering into a two-year contract that provides the customer with an option to renew the contract for an additional year. To reflect this economic substance in the accounting for the contract, the entity's accounting for the contract should reflect a two-year term and a renewal option for a third year that should be evaluated to determine whether it provides the customer with a material right that should be accounted for as a performance obligation.



Example 6-22: Determining whether contract renewal rights (resulting from termination rights) provide the customer with a material right when the entity makes an upfront nonrefundable payment to the customer (Question 21 of the FASB RRI Q&As)

Example 2: A vendor enters into a five-year contract to provide a service to a customer with payments due monthly (assume collection is probable and pricing reflects standalone selling price throughout the contract term). To secure the contract, the vendor makes an upfront payment to the customer. Contractually, the customer has the right to terminate the contract at any time with 30 days of notice without penalty. The vendor does not have the right to terminate the contract. Most customers do not terminate the contract, in part because of the time and effort required for set-up on the vendor's system and the cost that would be incurred to change vendors.

The contract is a month-to-month contract because the termination clause is akin to a renewal right. Because the prices charged for each month are at the standalone selling price there is no material right. The upfront payment made to the customer by the vendor does not affect the analysis of the material right because the failure to renew does not affect the customer's ability to retain the payment from the vendor and, therefore, would not be considered a penalty. As such, only the future options are considered and paragraph 606-10-55-43 clarifies that even if the contract provides a right to exercise an option because of a present contract, that option is considered a marketing offer if there is not a material right.

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RSM COMMENTARY: Accounting for the following issues under ASC 606 is discussed elsewhere in this guide: (a) termination penalties in Section 5.3.2, (b) consideration payable to the customer in Section 7.5 and (c) setup activities and the related costs in Section 6.1.4 and Section 13.1, respectively.

6.6.2 Determining whether customer options for additional goods or services are performance obligations

The question that arises when an entity includes an option for additional goods or services in a contract is whether that option is a performance obligation that should be accounted for separately. The answer to this question hinges on whether the option provides a material right to the customer that it would not have received without entering into the contract with the entity. In general, if an option included in a contract gives the customer the right to a discount that is incremental to the range of discounts typically given by the entity on the same goods or services to the same class of customer in the same geographical area or market, the option provides a material right to the customer that it would not have received without entering into the contract. Conversely, if an option included in a contract gives the customer the right to purchase products or services at their standalone selling prices in the future, the option does not provide a material right to the customer that it would not have received without entering into the contract. This type of option is essentially a marketing offer that is not accounted for until the customer exercises the option. Consider the following example.

Example 6-23: Determining whether the option to purchase parts represents a material right (Question 21 of the FASB RRI Q&As)

Example 1: An entity sells equipment and a consumable part for the equipment (both the equipment and the part are distinct goods based on the guidance in paragraphs 606-10-25-19 through 25-22 that do not meet the over time recognition criteria in paragraph 606-10-25-27). The equipment does not function without the consumable part, but the customer could resell the equipment. The standalone selling price of the equipment is CU 10,000 and the standalone selling price of each part is CU 100. The costs of the equipment and each part are CU 8,000 and CU 60, respectively.

Scenario A: The entity sells the equipment for CU 6,000 (40% discount from standalone selling price) with a contractual option to purchase each part for CU 100. There are no contractual minimums; however, the entity estimates the customer will purchase 200 parts over the 2 years. Assume, that the seller and customer have an exclusive contract where the customer cannot purchase the goods from other vendors during the contract term.

The parts underlying each option would not be considered a part of the contract and there is no material right. The transaction price is CU 6,000, which is entirely attributable to the equipment, and the entity would have a loss of CU 2,000 when it transfers control of the equipment to the customer.

Scenario B: The entity sells the equipment for CU 10,000 and each part for CU 80 (the entity concludes the 20% discount on parts is material). The customer is not required to purchase any parts; however, the option to purchase parts represents a material right. Assume the entity estimates 200 parts would be purchased and the standalone selling price of the material right is CU 4,000.

The discount on the option to purchase each part would give rise to a material right and the contract would have two performance obligations, the equipment and the material right. The transaction price (CU 10,000) would be allocated to the performance obligations based on the standalone selling price (4,000 [200 estimated purchases * 20 discount] for the material right and 10,000 for the equipment) of each performance obligation (CU 7,143 [10,000/14,000 * 10,000] allocated to the equipment and CU 2,857

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[4,000/14,000 * 10,000] to the material right). The allocated transaction price would be recognized as each performance obligation is satisfied. The entity would recognize a loss on the sale of the equipment and some of the transaction price is deferred until parts are transferred.



RSM COMMENTARY: In both scenarios, the variability in the quantity of parts the customer may buy gives rise to options (and not variable consideration) because the entity is not obligated to transfer (and the customer is not obligated to pay for) the parts until the customer exercises its option (and the entity transfers control of the parts to the customer). This is the case even though the entity has exclusive rights to sell parts to the customer and the entity will recognize a loss when control of the equipment is transferred to the customer.

In Scenario A, because the option does not represent a material right, the entity does not account for the customer's option to buy the parts until the customer exercises the option.

In Scenario B, because the option does represent a material right, part of the transaction price is allocated to the option and recognized as revenue as the entity transfers control of the parts to the customer (as a result of the customer exercising its option to purchase the parts).

When evaluating whether an option provides a material right, a question arises as to whether that evaluation should be done: (a) only in the context of the current transaction with the customer or (b) in the context of the current transaction with the customer as well as transactions it has entered into with the customer in the past and expects to enter into with the customer in the future. This issue was addressed in Question 12 of the FASB RRI Q&As, and the FASB staff and TRG concluded that when evaluating whether an option provides a material right, the entity should take into consideration all relevant transactions, which include current, past and future transactions with the customer that are relevant to the evaluation. Consider the following example.



Example 6-24: Evaluating whether a "Buy three and get one free" program includes an option that provides the customer with a material right (Question 12 of the FASB RRI Q&As)

Entity A offers a program in which customers who have purchased three products over a given period of time may receive a fourth product free. Based on its historical data, Entity A determines that it is likely that its customers will receive a free product.

After a customer purchases the first of the three products, the customer has obtained an option (that is, an escalating right) that allows the customer to receive a free product if the customer chooses to purchase two additional products. Similarly, after the customer purchases the second of the three products, it receives an option that allows the customer to receive a free product if the customer chooses to purchase one additional product. After completion of the third product purchase, the customer has an option to obtain a free product. As a result, the standalone selling price of each option may be different.

Assume that in the current transaction, which is the customer's first of the three required purchases, Customer Y purchases a product from Entity A at its observable standalone selling price of $6. Entity A concludes that the standalone selling price of the customer option in this transaction is $0.30.

Entity A would consider that Customer Y has in-substance earned one-third of a free product in the current transaction (or in other words, has earned the right to receive one free product if the customer purchases two additional products). Entity A also would consider whether Customer Y is likely to purchase two additional products that will entitle it to a free product.

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RSM COMMENTARY: This example illustrates that the entity should take into consideration more than just the option it received in the current transaction when evaluating whether the entity is providing the customer with a material right. In other words, it should consider more than just whether the estimated standalone selling price of the customer option resulting from its first purchase ($0.30) provides the customer with a material right in relation to its first purchase. While the entity would consider this information, it also would consider other information, such as the likelihood of the customer buying two additional products in the future to be entitled to the free product.

Another question that arises when evaluating whether an option provides a material right is whether the entity should consider only quantitative factors or both quantitative and qualitative factors. This issue was addressed in Question 13 of the FASB RRI Q&As, and the FASB staff and TRG concluded that both quantitative and qualitative information should be considered by an entity when evaluating whether an option provides a material right. Consider the following examples.



Example 6-25: Evaluating whether a discount voucher includes an option that provides the customer with a material right (Question 13 of the FASB RRI Q&As)

Entity A provides its customers who purchase goods on a particular day with a voucher for 25 percent off their next purchase (of any size). The voucher may be applied against the purchase of any product and expires after 60 days. Based on its historical data for similar offerings, Entity A determines that customers typically use the voucher to make an additional purchase that is, on average, more expensive than what a customer would typically purchase without a voucher. Entity A does not offer its customers any other discounts throughout the year.

On the day that Entity A offers its customers vouchers, Customer Y purchases a product for $200 and Customer Z purchases a product for $10.

Entity A would consider the quantitative nature of the rights received by each customer based on the standalone selling price of the voucher in relation to the transaction with the customer. Entity A also would consider that the voucher has given both Customers Y and Z the qualitative nature of the rights in that both customers have the opportunity to receive a 25 percent discount on a future purchase, including purchases for products that may have an observable standalone selling price that is significantly higher than the selling prices of the products purchased by Customers Y and Z in the current transactions.



RSM COMMENTARY: This example illustrates that the entity should take into consideration more than just quantitative information about the option it received in the current transaction when evaluating whether the entity is providing the customer with a material right. In other words, it also should consider qualitative information related to the types of purchases the customers may make in the future to maximize the benefit they receive from the discount voucher. Example 6-27 illustrates how to account for a discount voucher that includes an option that provides the customer with a material right.

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Example 6-26: Evaluating whether a nonrefundable upfront fee and contract renewal right result in an option that provides the customer with a material right (Question 13 of the FASB RRI Q&As)

Entity A and Customer Y enter into a 12-month service contract for $60 per month. All customers are required to agree to a 12-month contract. In addition to the monthly fee, Customer Y also must pay a $120 nonrefundable fee at contract inception. The upfront fee is not considered to transfer a promised good or service. Customer Y will only pay the $120 fee once as long as it continuously remains a customer of Entity A. Entity A's customers have multiple service providers available to them in their geographic area. While monthly service fees are similar throughout the geographic area, some of those service providers do not charge customers upfront fees to initiate services for customers who are existing customers of a competitor.

The contract also contains a renewal option that allows Customer Y to renew the contract on a month-to-month basis. The contract does not stipulate the renewal price, but Entity A does not operate in a volatile industry and service rates have historically remained relatively stable (that is, the monthly fee is not expected to significantly increase or decrease). As a practical alternative to estimating the standalone selling price of the renewal option, Entity A evaluates the renewal option by reference to the services provided (in accordance with paragraph 606-10-55-45).

Entity A would evaluate the quantitative factors based on an evaluation of whether its customers receive a material right with respect to renewal of the services because they do not have to pay an additional $120 upfront fee at the beginning of the renewal period. In this case, Entity A would consider whether the renewal price that Customer Y will pay (that is, $60/month) compared with the allocated price that a new customer would pay for the same services ($120/12 = $10 + $60/month fee = $70) provides the customer with a material right.

Entity A would also consider qualitative factors such as the availability and pricing of service alternatives. For example, Entity A might consider the fact that after the one-year fixed term, Customer Y could get substantially similar services from one of Entity A's competitors at the same price as it would receive those services from Entity A (that is, $60/month). This might call into question whether the option to renew Entity A's services at $60/month provides Customer Y with a material right that it would not have received without entering into the initial services contract with Entity A.



RSM COMMENTARY: This example illustrates that the entity should take into consideration more than just quantitative information when evaluating whether payment of an upfront nonrefundable fee together with the contract renewal right provides the customer with a material right. In other words, it also should consider qualitative information, such as whether its competitors charge an upfront nonrefundable fee. Example 6-28 illustrates how to account for a contract renewal right that includes an option that provides the customer with a material right. Section 7.1.2 discusses the accounting for nonrefundable upfront fees.

6.6.3 Accounting for an option that is a performance obligation

When an option is a performance obligation, an entity must determine the standalone selling price for the option for purposes of allocating a portion of the transaction price to the option (see Section 6.6.3.1). In addition, the transaction price does not include any additional consideration that would result from the customer exercising the option because the option is a material right that the customer is implicitly obligated to pay for as part of the contract in which it is included. The transaction price allocated to the option is recognized as revenue when or as the option is exercised (see Section 6.6.3.2), or if it is not

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exercised, when the option expires unused. This accounting model essentially reflects the customer partially paying in advance for goods and services it will purchase when it exercises the option.



Spotlight on change

Legacy GAAP for software transactions provided guidance related to accounting for significant and incremental discounts offered on future purchases that resulted in a proportionate amount of that discount being applied to each element in the contract based on its fair value (provided VSOE of fair value exists). Because other legacy GAAP did not address the accounting for significant and incremental discounts, the guidance applied to software transactions often was analogized to in practice when accounting for other transactions. In addition, a renewal option was only accounted for separately under legacy GAAP if the renewal pricing represented a significant and incremental discount, which is typically not the case. Given that ASC 606 addresses the accounting for options for additional goods or services more holistically than legacy GAAP, how an entity accounts for a contract with one or more renewal options could significantly change.

6.6.3.1 Estimating the standalone selling price of an option that is a performance obligation

While unlikely to be the case, if there is a directly observable standalone selling price for the option, it should be used for allocation purposes. For the more likely scenario in which a directly observable standalone selling price for the option is not available, the entity must estimate the standalone selling price (see Section 8.2). In doing so, the entity should ensure that the estimate reflects both of the following:

- *If the customer could get a discount without exercising the option, that discount should be taken into consideration in the standalone selling price of the option.* For example, consider a situation in which a customer has an option to purchase product from the entity in the future at a 30 percent discount. If the customer could get a 10 percent discount on future purchases of the product without the option because, for example, the entity is offering a 10 percent discount on future purchases of any product to all customers, that should be taken into consideration in estimating the standalone selling price of the option. The effects of the customer being able to get the 10 percent discount without the option decreases the value of the option, all other things being equal.
- *How likely it is that the customer will exercise the option.* For example, consider a situation in which a customer has an option to purchase up to $1,000 of product from the entity in the future at a 30 percent discount. If the customer is only expected to use the discount to purchase $800 of product, the standalone selling price of the option should reflect the expected purchases of $800 and not the maximum possible purchases of $1,000. Conceptually, this is a form of breakage (i.e., unexercised customer rights), which is discussed in Section 9.5.

Given the difficulties that may arise in estimating the standalone selling price of an option for additional goods or services, an entity may instead allocate a portion of the transaction price to the optional goods or services based on the goods or services expected to be provided in connection with the option and the related expected consideration. However, this practical alternative may only be elected if the optional goods or services are:

- Similar to the original goods or services in the contract
- Provided in accordance with the terms of the original contract

While the type of option for additional goods or services that most likely would qualify for this practical alternative, depending on the facts and circumstances, is a contract renewal option, other types of options also may qualify.

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Example 6-27: Determining whether a discount voucher is a performance obligation, estimating its standalone selling price and accounting for its redemption (ASC 606-10-55-336 to 55-339)

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.

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.

To estimate the standalone selling price of the discount voucher in accordance with paragraph 606-10-55-44, the entity estimates an 80 percent likelihood that a customer will redeem the voucher and that a customer will, on average, purchase $50 of additional products. Consequently, the entity's estimated standalone selling price of the discount voucher is $12 ($50 average purchase price of additional products × 30 percent incremental discount × 80 percent likelihood of exercising the option). The standalone selling prices of Product A and the discount voucher and the resulting allocation of the $100 transaction price are as follows:

Performance Obligation	Standalone Selling Price
Product A	$100
Discount voucher	12
Total	$112

Performance Obligation	Allocated Transaction Price	
Product A	$89	($100 ÷ $112 × $100)
Discount voucher	11	($12 ÷ $112 × $100)
Total	$100	

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.

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RSM COMMENTARY: While not explicitly stated, the entity concludes that it should account for the promise to provide the incremental discount of 30 percent as a performance obligation because it represents a material right the customer would not have received if it had not entered into the contract with the entity to purchase Product A for $100.

Assuming the inventory cost of the $100 product purchased by the customer is $40, the entity records the following journal entry when it transfers control of Product A to the customer:

	Debit	Credit
Cash	$100	
Cost of goods sold	40	
Revenue		$89
Discount voucher liability		11
Inventory		40

The following journal entry summarizes how the entity would recognize revenue if the customer used the voucher to purchase products totaling $30, $50 or $70 over the 30-day period, respectively:

	$30		$50		$70	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash (Note 1)	$18		$30		$42	
Discount voucher liability	11		11		11	
Revenue (Note 2)		$29		$41		$53

Note 1: The cash reflected for each purchase was calculated by reducing the purchase price ($30, $50 or $70) by the 40 percent discount. For example, if the discount voucher were used to purchase an item with a price of $30, the cash received on that purchase would be $18 ($30 × [1 – 40%]).

Note 2: The revenue reflected for each purchase is the amount the customer pays for the current purchase plus the discount voucher liability recorded when the customer made the purchase that entitled it to the discount voucher.

The entity should take its experience with the redemption of this discount voucher into consideration when estimating the standalone selling prices of similar discount vouchers in the future.



Example 6-28: Determining whether a contract renewal option for maintenance services is a performance obligation, estimating its standalone selling price and accounting for the renewals (ASC 606-10-55-343 to 55-352)

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

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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.

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.

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.

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).

At contract inception, the entity determines the expected consideration for each contract is $2,710 [$1,000 + (90 percent × $1,000) + (81 percent × $1,000)]. The entity also determines that recognizing revenue on the basis of costs incurred relative to the total expected costs depicts the transfer of services to the customer. Estimated costs for a three-year contract are as follows:

Year 1	$600
Year 2	$750
Year 3	$1,000

Accordingly, the pattern of revenue recognition expected at contract inception for each contract is as follows:

Expected Costs Adjusted for Likelihood of Contract Renewal			Allocation of Consideration Expected	
Year 1	$600	($600 x 100%)	$780	[($600 ÷ $2,085) x $2,710]
Year 2	675	($750 x 90%)	877	[($675 ÷ $2,085) x $2,710]
Year 3	810	($1,000 x 81%)	1,053	[($810 ÷ $2,085) x $2,710]
Total	$2,085		$2,710	

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)].

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.

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)].

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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.



RSM COMMENTARY: Provided below is a summary of how the entity would record the revenue in each year, assuming the actual number of contract renewals was the same as initially expected:

	Year 1		Year 2		Year 3	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$100,000		$90,000		$81,000	
Revenue		$78,000		$87,700		$105,300
Contract renewal option liability		22,000		2,300	24,300	

This example illustrates how the accounting model for options treated as performance obligations essentially reflects the customer partially paying in advance in Years 1 and 2 for some of the services it will purchase in Year 3 when it exercises its option to renew the contract for that year.

6.6.3.2 Accounting for the customer's exercise of an option that provides a material right

The FASB staff and TRG discussed how an entity should account for the customer's exercise of an option that provides a material right. This issue was addressed in Question 15 of the FASB RRI Q&As, and the FASB staff and TRG concluded that both of the following methods are supportable under ASC 606 for purposes of accounting for the customer's exercise of an option that provides a material right:

- *Contract continuation.* Under this method, the entity should account for the continuation of the contract that included the option by:
  - Continuing to account for the performance obligations previously identified in the contract (other than the one related to the option) as it otherwise would have absent exercise of the option (i.e., recognize as revenue the transaction price previously allocated to those performance obligations when [or as] they are satisfied)
  - Allocating the additional transaction price it expects to be entitled to as a result of the customer's exercise of the option to the performance obligation(s) created by the customer's exercise of the option
  - Recognizing the transaction price allocated to the performance obligation(s) created by the customer's exercise of the option when (or as) the performance obligation(s) is (are) satisfied
- *Contract modification.* Under this method, the entity should evaluate: (a) any performance obligation created by the customer's exercise of the option as a change in the scope of the contract and (b) any consideration to which the entity expects to be entitled as a result of the customer's exercise of the option as a change in the price of the contract. The entity should use the contract modification guidance in ASC 606 (see Section 5.5) to determine the appropriate accounting model (e.g., separate contract, prospective, cumulative catch-up adjustment) to apply to the change in scope and (or) price resulting from the customer's exercise of the option.

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The TRG and FASB staff considered and rejected a view that the customer's exercise of an option that provides a material right should (or may) be accounted for as variable consideration. They did not believe this view was supportable under ASC 606.

An entity should elect an accounting policy related to whether it will use the contract continuation or contract modification method to account for the customer's exercise of an option that provides a material right, disclose that accounting policy and consistently apply it in similar facts and circumstances. Consider the following examples.



Example 6-29: Using the contract continuation and contract modification methods to account for the customer's exercise of an option that provides a material right (Question 15 of the FASB RRI Q&As)

Entity enters into a contract with Customer to provide two years of Service A for $100. The arrangement also includes an option for Customer to purchase two years of Service B for $300. The standalone selling prices of Services A and B are $100 and $400, respectively. Entity concludes that the option to purchase Service B at a discount provides Customer with a material right. Entity's estimate of the standalone selling price of the option is $33.

Entity allocates the $100 transaction price to each performance obligation as follows:

	TP	SSP	Percent	Allocation
Service A		$100	75%	$75
Option to Purchase Service B		33	25%	25
	$100	$133	100%	$100

Upon executing the contract, Customer pays $100 and Entity begins transferring Service A to Customer. The $75 allocated to Service A will be recognized over the two-year service period. The $25 allocated to the option to purchase Service B is deferred until Service B is transferred to Customer or the option expires.

Six months after executing the contract, Customer exercises its option to purchase two years of Service B for $300.

Provided below are the results of applying each of the two methods the FASB staff and TRG concluded are supportable under ASC 606 (from Question 15 of the FASB RRI Q&As):

- *Contract continuation:*

  Entity accounts for Customer's exercise of its option to purchase Service B as a continuation of the contract. The transaction price is updated to reflect the consideration received in exchange for Service B. The amount allocated to Service A, less any amounts previously recognized as revenue (for example, Entity would have recognized revenue of $18.75 for Service A when the option was exercised six months into the two-year contractual term), is recognized as revenue over the remainder of the two-year period over which Service A is transferred. The $300 of consideration related to service B is added to the amount previously allocated to the option to purchase Service B (that is, a total of $325) and is recognized as revenue over the two-year period over which Service B is transferred. In this example, none of the transaction price allocated to the material right had been recognized as revenue at the date the option was exercised by Customer.

- *Contract modification:*

  Entity may account for Customer's exercise of its option to purchase Service B as a contract modification. Entity evaluates the contract modification guidance in paragraph 606-10-25-12 and

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determines that the contract modification should not be accounted for as a separate contract because the price of the contract did not increase by an amount of consideration that reflects Entity's standalone selling price of Service B.

Entity must then evaluate the guidance in paragraph 606-10-25-13 to determine how it should account for the modification. Depending on its evaluation of the guidance in paragraph 606-10-25-13, Entity may be required to recognize a cumulative catch-up adjustment to revenue on the date of the modification. A cumulative catch-up adjustment would not be recognized under View A or, under paragraph 606-10-25-13(a) if the entity concludes that the remaining goods or services to be provided after the modification are distinct from those transferred to the customer before the modification. However, a cumulative catchup adjustment would be required if Entity accounts for the modification in accordance with paragraphs 606-10-25-13(b) or (c).



RSM COMMENTARY: In applying the contract modification method, the entity should not account for Service B as if it were a separate contract because Service B is not priced at its standalone selling price. The next consideration is whether Services A and B are distinct from each other. In the very likely case that Services A and B are distinct, the entity would account for the modification prospectively. The transaction price would be $381.25 ($81.25 [$100 cash received for Service A – $18.75 revenue recognized for Service A up to the time the option for Service B was exercised] + $300 cash received for Service B). Assuming the standalone selling prices for 1.5 years of Service A and 2 years of Service B are $75 and $400, respectively, the following amounts would be allocated to Services A and B:

	TP	SSP	Percent	Allocation
Service A		$75	15.8%	$60.24
Service B		400	84.2%	321.01
	$381.25	$475	100.0%	$381.25

In the very unlikely case that Services A and B are not distinct from each other, the entity would account for the modification using a cumulative catch-up adjustment.

It is important to point out that the entity does not have a choice of accounting for the exercise of the option as a contract modification using any of the modification accounting models (e.g., separate contract, prospective, cumulative catch-up adjustment). The model that should be used depends on the facts and circumstances, which includes whether the price of the services sold under the option is the standalone selling price of those services and whether Service A and Service B are distinct from each other. Detailed discussion and examples of the contract modification guidance in ASC 606 is provided in Section 5.5.

6Q.6.3.2.1 When should the transaction price allocated to an option that is a performance obligation be recognized if the option never expires?

As noted in Section 6.6.3, the transaction price allocated to an option is recognized as revenue when or as the option is exercised, or if it is not exercised, when the option expires unused. In the case of an option with no expiration date (such as in some airline or hotel rewards programs), it is clear revenue would be recognized as the option is exercised. However, if the option remains unexercised, there is no specific authoritative guidance that addresses the timing of revenue recognition given there's no expiration date. In his scenario, we believe it is reasonable to apply the breakage model discussed in

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Section 9.5 and to recognize revenue when the likelihood that the customer will exercise the option becomes remote.

6.6.4 Customer loyalty programs

A customer loyalty program is an example of a customer option for additional goods or services and should be evaluated as such. In other words, an entity should determine whether the option for additional goods or services provided in a customer loyalty program is a material right that the customer would not have received had it not entered into the contract with the entity. As discussed earlier, when evaluating whether an option provides a material right, the entity should consider: (a) both quantitative and qualitative information about the customer loyalty program and (b) all relevant transactions related to the customer loyalty program, which includes current, past and future transactions. Consider the following example.



Example 6-30: Evaluating whether a specific loyalty program includes an option that provides the customer with a material right (Question 12 of the FASB RRI Q&As)

Entity A has a loyalty program in which its customers accumulate one point for every dollar spent. Points may be exchanged for free products when the customer accumulates enough points. Based on its historical data, Entity A determines that it is likely that its customers will accumulate enough loyalty points to receive a free product.

In the current transaction, Customer Y purchases a product from Entity A for $50 and receives 50 loyalty points. Entity A concludes that each loyalty point has a standalone selling price of $0.01.

Entity A would consider whether the loyalty points earned from the current transaction are expected to contribute to a material right that the customer has (or will accumulate). The evaluation would consider that an element of the right granted to Customer Y in the current transaction is the customer's ability to accumulate loyalty points that will entitle the customer to a free product.



RSM COMMENTARY: By tying whether a material right exists in this example to the customer's ability to accumulate loyalty points on future transactions, the TRG and FASB staff rejected the position that if the loyalty points earned in the current transaction are not enough to entitle the customer to a benefit (e.g., free hotel room stay, $100 discount), then they do not provide the customer with a material right.

Customer loyalty programs come in all shapes and sizes. In addition, such programs are more common in some industries than others. For example, in the financial institutions industry, credit card-issuing banks often offer cardholder rewards programs. The FASB staff and TRG discussed whether such programs are within the scope of ASC 606 (see Question 3Q.1.6). This issue was addressed in Question 2 of the FASB RRI Q&As, in which the FASB staff provided some key considerations involved in accounting for cardholder rewards programs, such as understanding the roles of the various parties involved in such programs and considering whether the card-issuing bank may have another customer(s) in addition to the cardholder. Other industries in which customer loyalty programs are prevalent are the gaming, airline and hospitality industries. Chapter 6, Chapter 10 and Chapter 17, respectively, of the Revenue Recognition AAG provide guidance on issues having to do with customer loyalty programs in those industries. Determining whether a customer loyalty program includes an option that provides the customer with a material right will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

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Determining that a customer loyalty program includes an option that provides the customer with a material right results in the entity accounting for that option as a performance obligation. To account for that performance obligation, the entity must estimate its standalone selling price and allocate a portion of the transaction price to the performance obligation. The transaction price allocated to the performance obligation is recognized as revenue when or as the underlying option is exercised (see Section 6.6.3.2), or if it is not exercised, when the option expires unused. Consider the following example.



Example 6-31: Accounting for a customer loyalty program (ASC 606-10-55-353 to 55-356)

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.

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

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

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

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



RSM COMMENTARY: The entity is accounting for the customer loyalty program on a portfolio basis. Doing so is only appropriate if it will not provide a materially different result compared to accounting for the customer loyalty program on a customer-by-customer basis. The entity should have documentation supporting its ability to account for the program on a portfolio basis.

6.7 Contract manufacturing

In the most basic sense, contract manufacturing is an entity outsourcing the manufacture of a product or a product component to another entity. For example, an entity and its customer may enter into a contract under which the entity manufactures 20 complex pieces of equipment in accordance with the customer's specifications. Under legacy GAAP, the entity's accounting for this contract could result in the identification of multiple elements—one for each device to be produced—that should be accounted for

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separately. However, as illustrated in the following example, the entity's accounting for this contract under ASC 606 could result in the identification of one performance obligation, depending on the specific facts and circumstances.



Example 6-32: Identifying the performance obligations in a contract to manufacture multiple units of a specialized complex device (ASC 606-10-55-140A to 140C)

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.

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.

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.



RSM COMMENTARY: Entities that provide contract manufacturing services should carefully consider their own facts and circumstances in the context of ASC 606 to ensure they have obtained an appropriate understanding of the nature of the promised goods or services included in the contract and identified the appropriate performance obligation(s). If that were not done in this example, the entity might have inappropriately concluded that each highly complex and specialized device was a performance obligation. Arrangements for contract manufacturing services are often unique and complex. As a result, identifying the performance obligations when such services are being provided to the customer will require significant judgment to be exercised and careful consideration of the entity's own relevant facts and circumstances.

Whether the entity in this example should recognize revenue for its single performance obligation over time or at a point in time is discussed in Section 9.2.

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Spotlight on change

Under legacy GAAP, accounting for contract manufacturing services could have resulted in the identification of multiple elements—one for each device to be produced—that should be accounted for separately. Given the stark difference in how this type of arrangement could be accounted for under legacy GAAP vs. ASC 606, entities that provide contract manufacturing services or other contract services should carefully consider this example and the guidance on identifying the performance obligations in ASC 606 when accounting for their contracts.

6.8 Nonrecurring engineering and preproduction (NE&P) activities

It is not uncommon for an entity to undertake nonrecurring engineering and preproduction (NE&P) activities for a customer, often in connection with fulfilling a long-term supply contract or in anticipation of entering into such a contract. For example, an entity may enter into a contract with its customer to produce a component that its customer will use in the production of a vehicle. In connection with that contract, the entity may be involved in the design and development of the component. In addition, the entity may need to design and develop molds, dies and other tools to facilitate its production of the component. The entity may or may not be explicitly paid or reimbursed for these NE&P activities.

6.8.1 Determining whether reimbursements for NE&P activities generate revenue

Diversity in practice exists with respect to whether cost reimbursements from the customer for NE&P activities should be accounted for as revenue. In some cases, entities have concluded that the NE&P activities do not generate revenue and should be accounted for as cost reimbursements under other applicable accounting guidance, such as ASC 340-10, ASC 340-40 or ASC 730. In other cases, entities have concluded that the NE&P activities generate revenue and any related reimbursements should be accounted for as such.

Section 6.8.2 and Section 6.8.3 address the following two topics, respectively: (a) the accounting under ASC 606 for NE&P activities that generate revenue and (b) the accounting for NE&P activities that do not generate revenue. The accounting for costs incurred in performing NE&P activities is discussed in Section 13.1.1.1.

6.8.2 Accounting under ASC 606 for NE&P activities that generate revenue

The FASB, its staff and the TRG discussed the application of ASC 606 to NE&P activities. Question 65 of the FASB RRI Q&As includes a flowchart that captures the major decision points and accounting implications of applying ASC 606 to such activities, including:

- To the extent an entity concludes that NE&P activities generate revenue that should be accounted for under ASC 606, any payments or cost reimbursements from the customer for such activities should be considered part of the transaction price for the contract.
- The entity must determine whether the NE&P activities: (a) transfer a promised good or service to the customer or (b) are setup activities that do not transfer a promised good or service to the customer.

Determining whether NE&P activities should be considered promised goods or services or setup activities was discussed by the FASB staff and TRG and addressed in Question 16 of the FASB RRI Q&As. The basis for these discussions was Question 1 in TRG 46, “Pre-Production Activities,” and a summary of the discussions is provided in TRG 49, “November 2015 Meeting – Summary of Issues Discussed and Next Steps.” Paragraphs 9 and 10 in TRG 46 provide examples of NE&P activities that would be considered a promised good or service. For additional information about determining whether NE&P activities should be considered promised goods or services or setup activities, refer to the flowchart and corresponding discussion in the board meeting handout and the relevant discussion in TRG 46 and TRG 49.

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If the entity determines that the NE&P activities transfer one or more promised goods or services to the customer, the entity must determine whether the promised goods or services are distinct:

- If so, each distinct promised good or service is accounted for as a performance obligation and the transaction price allocated to the performance obligation is recognized as revenue when or as it is satisfied (i.e., when or as control of the promised good or service transfers to the customer).
- If not, each promised good or service is bundled with other promised goods or services until there is a bundle of promised goods or services that is distinct, in which case that bundle of promised goods or services is accounted for as a performance obligation, and the transaction price allocated to the performance obligation is recognized as revenue when or as it is satisfied (i.e., when or as control of the bundle of promised goods or services transfers to the customer).

Determining whether a promised good or service is distinct is discussed in detail in Section 6.2. In addition, determining whether the transaction price allocated to a performance obligation should be recognized when (at a point in time) or as (over time) it is satisfied is discussed in Section 9.2.

If the entity determines that the NE&P activities are setup activities that do not transfer a promised good or service to the customer, it does not recognize revenue when or as it performs those activities. For example, if the entity determines that the NE&P activities are performed to set up the entity to produce vehicle components for the customer under a long-term supply arrangement, revenue is not recognized as the entity performs the NE&P activities, but instead when or as it satisfies its performance obligations related to producing and delivering the vehicle components.

6.8.3 Accounting for NE&P activities that do not generate revenue

To the extent an entity concludes that NE&P activities do not generate revenue that should be accounted for under ASC 606, it should account for such activities in accordance with other applicable GAAP. Consideration should be given to whether the guidance in ASC 610-20 related to transfers of nonfinancial assets applies. While much of the recognition and measurement guidance in ASC 606 may ultimately be applied to certain transfers of nonfinancial assets under ASC 610-20, the proceeds related (or allocated) to such transfers are not reflected as revenue in the income statement.

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7. Step 3: Determine the transaction price

7.1 General requirements for determining the transaction price

Transaction price is defined in ASC 606-10-32-2 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)." In addition to the contract terms, the entity's customary business practices also should be taken into consideration in determining the transaction price. In general, the entity does not take the customer's credit risk into consideration when estimating the transaction price except, for example, when the contract includes a significant financing component.

The entity should assume that the contract will be fulfilled in accordance with its terms and customary business practices for purposes of determining the transaction price. In other words, the entity should not assume or consider cancellation, renewal or modification of the contract.

The transaction price is determined at contract inception and should include the fixed cash consideration as well as any of the following:

- Noncash consideration promised by the customer (Section 7.2)
- Variable consideration, subject to an overall constraint (Section 7.3)
- Significant financing component (Section 7.4)
- Consideration payable to the customer (Section 7.5)

7.1.1 Sales and similar taxes

An entity may elect an accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the entity's revenue-generating transactions with its customers. Examples of taxes to which this accounting policy would apply if elected are sales taxes, use taxes, value-added taxes, excise taxes and other similar taxes (i.e., sales and similar taxes). Examples of taxes to which this accounting policy would not apply if elected are gross receipts taxes and taxes imposed during the inventory procurement process.

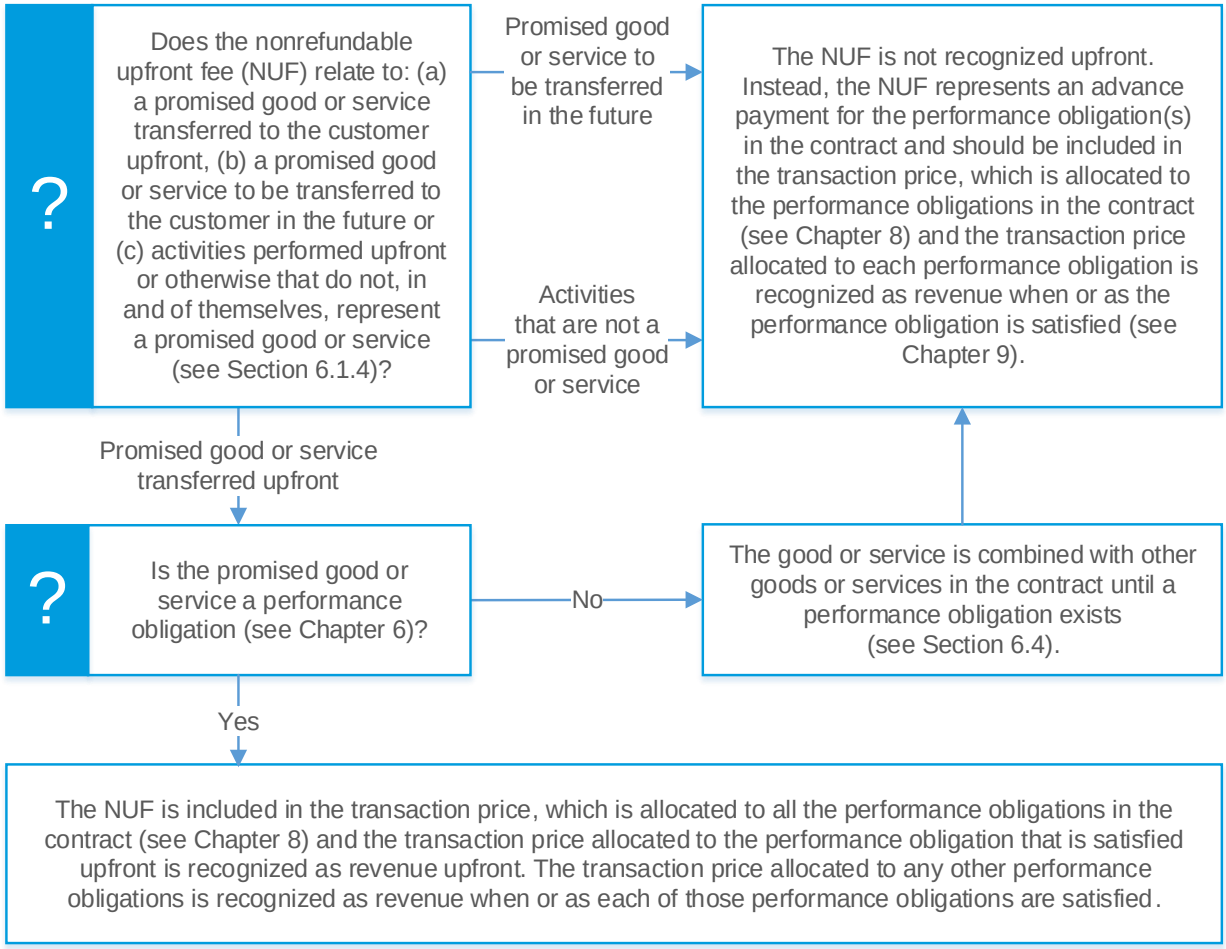
If an entity elects this accounting policy, it must apply the policy to all sales and similar taxes. In other words, an entity cannot choose to apply the policy to some sales and similar taxes and not apply the policy to other sales and similar taxes. In addition, if the entity elects the accounting policy, the accounting policy disclosure requirements in ASC 235 apply.

If an entity does not elect the accounting policy, it must determine whether it is a principal or an agent with respect to each sales or similar tax assessed on its revenue-generating transactions. If it is a principal, the sales or similar tax is included in the transaction price. If it is an agent, the sales or similar tax is not included in the transaction price. Making the determination as to whether the entity is a principal or an agent with respect to each sales or similar tax in every tax jurisdiction in which its revenue-generating transactions are subject to such taxes could be a very onerous exercise. It is for this reason that the FASB provided the alternative accounting policy that an entity may choose to elect.

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7.1.2 Nonrefundable upfront fees

In general, a nonrefundable upfront fee is only recognized as revenue upfront if it relates to a good or service that is a performance obligation that is satisfied upfront. The facts and circumstances that are necessary for that accounting result, as well as the other potential accounting results for nonrefundable upfront fees, are illustrated in the flowchart that follows.



As explained in the flowchart, the timing of when a nonrefundable upfront fee should be recognized (whether upfront or otherwise) depends on the nature of the performance obligations in the contract. If one of those performance obligations is a contract renewal option that provides the customer with a material right (see Section 6.6.2), the period over which (or in which) the upfront nonrefundable fee is recognized could extend beyond the contract term as determined for purposes of applying ASC 606 (see Section 5.3). In addition, the presence of a nonrefundable upfront fee can, in certain circumstances, lead to a conclusion that a contract renewal option provides the customer with a material right that it would not have received without entering into the contract with the customer. Consider the following examples.

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Example 7-1: Accounting for a nonrefundable upfront activation fee and a contract renewal right (Question 52 of the FASB RRI Q&As)

Entity charges a $50 one-time activation fee and agrees to provide Customer with services on a month-to-month basis at a price of $100 per month. Customer is under no obligation to continue to purchase the monthly service and Entity has not committed to any pricing levels for the service in future months. Because the activity of signing up Customer for service does not result in the transfer of a good or service, it does not represent an additional promised service. Rather, the activation fee is an advance payment for Entity's services and should, therefore, be deferred and recognized as the future service is provided. Entity's average customer life is two years.

Assume the $50 one-time activation fee is nonrefundable.



RSM COMMENTARY: This example was discussed by the FASB staff and TRG in Question 52 of the FASB RRI Q&As and the FASB staff and TRG concluded that the period of time over which the nonrefundable activation fee should be recognized depends on whether it provides the customer with a material right (see Section 6.6.2):

- *Payment of the nonrefundable activation fee provides the customer with a material right related to contract renewal.* The activation fee should be recognized over the period the customer is expected to benefit from paying the activation fee. The period over which the customer is expected to benefit from paying the activation fee may not necessarily be the two-year average customer life. The entity should take various qualitative and quantitative factors into consideration in identifying the period of time the customer is expected to benefit from paying the activation fee, which are similar to the factors considered in determining whether the nonrefundable activation fee provides the customer with a material right (see discussion of some of those factors later in this commentary).
- *Payment of the nonrefundable activation fee does not provide the customer with a material right related to contract renewal.* The activation fee should be included in the transaction price for the contract and recognized as revenue as the services the entity is obligated to provide under the contract are transferred to the customer. As a result, the transaction price of $150 ($100 monthly fee for the one-month contract term and $50 activation fee) should be recognized over the one-month contract term.

To determine whether the nonrefundable activation fee provides the customer with a material right, an entity should consider the guidance on determining whether an option to purchase additional goods or services represents a material right, which is discussed in detail in Section 6.6.2. Based on that guidance, the FASB staff provided a number of factors that the entity should consider, including the following:

- Does the renewal price of $100 per month the customer would pay provide it with a material right compared to the $150 ($50 activation fee and $100 monthly fee) a new customer would pay for the same service?
- Could the customer obtain equivalent service from another service provider, and if so, how does what the customer would pay the other service provider compare to what it would pay the entity? For example, does the other service provider charge an activation fee that is nonrefundable, and if so, in what amount?
- How does the average customer life compare to the one-month contract period? For example, is the average customer life significantly longer than the contract period because

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customers are incentivized to continue to purchase services from the entity so that they do not have to pay another activation fee?

When the entity concludes that paying the nonrefundable activation fee provides the customer with a material right, considering these factors also may assist in identifying the period over which the customer expects to benefit from paying that fee.

Determining whether the payment of an upfront nonrefundable fee represents a material right will require significant judgment to be exercised and careful consideration of all the facts and circumstances.



Example 7-2: Accounting for an upfront nonrefundable fee related to setup activities (ASC 606-10-55-358 to 55-360)

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.

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.

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.



RSM COMMENTARY: Because the nonrefundable upfront fee relates to activities performed upfront that do not, in and of themselves, represent a promised good or service, the nonrefundable upfront fee represents an advance payment for the transaction processing services, which is the only performance obligation in the contract, given that the contract renewal option does not provide the customer with a material right (see Section 6.6.2). As a result, the nonrefundable upfront fee is recognized as revenue over the contract term (see Section 5.3) as control of the transaction processing services is transferred to the customer.

Example 6-28 illustrates the accounting consequences if the contract renewal option is a performance obligation because it provided the customer with a material right (see Section 6.6.2).



Example 7-3: Accounting for an upfront nonrefundable fee related to a good or service for which control transfers to the customer upfront

Company A enters into a contract with Customer B. Company A is licensing IP to Customer B and providing services related to the IP over the two-year contract term. Company A receives a nonrefundable upfront payment of $5 million from Customer B upon transferring control of the IP to Customer B upfront.

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There is no separate compensation for the services Company A provides to Customer B over the two-year contract term. Neither Company A nor Customer B has the right to terminate the contract.

Case 1

Company A analyzes its facts and circumstances and concludes that: (a) the license of IP and services are distinct and should be separately accounted for as performance obligations and (b) the license of IP represents a right to use the IP (see Chapter 10). Company A estimates the standalone selling prices of the license of IP and services as $3.6 million and $2.4 million, respectively (see Section 8.2). Company A concludes that a significant financing component does not exist because Customer B dictates when Company A provides the services (see Section 7.4.1).

To determine the amount of the nonrefundable upfront fee that should be recognized as revenue related to each of the performance obligations, Company A allocates the transaction price as follows (see Chapter 8):

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($5,000,000) to each PO
License of IP	$3,600,000	60%	$3,000,000
Services	2,400,000	40%	2,000,000
Total	$6,000,000	100%	$5,000,000

Based on the allocation of the transaction price, Company A determines that it should recognize $3 million of the $5 million nonrefundable upfront fee when it satisfies the performance obligation made up of the license of IP. Because the license of IP is a right to use IP, it is a performance obligation that is satisfied at a point in time (see Section 10.2.1). The point in time the license performance obligation is satisfied is when control of the IP is transferred to Customer B (see Section 10.2.1). As a result, because control of the IP transfers to Customer B upfront, Company A recognizes $3 million of revenue upfront. The $2 million excess of the nonrefundable upfront fee over the portion of that fee recognized upfront (which is also the amount allocated to the services performance obligation) is recorded as a contract liability and recognized as revenue when (or as) the services performance obligation is satisfied.

If the license of IP represented a right to access IP (see Section 10.2.1), the $3 million allocated to that performance obligation would have been recognized over time instead of upfront.

Case 2

Assume the same facts as Case 1, except Customer B is obligated to pay Company A as follows: (a) $2.5 million at the beginning of the license period and (b) $2.5 million at the beginning of the second year of the license.

For the same reasons provided in Case 1, Company A recognizes $3 million of revenue upfront. The $500,000 excess of the transaction price allocated to the license of IP (i.e., the performance obligation satisfied upfront) over the nonrefundable upfront fee is recorded as a receivable if Company A has an unconditional right to receive the second payment of $2.5 million from Customer B. Otherwise, the $500,000 excess is recorded as a contract asset (see Section 14.3).

Case 3

Company A analyzes its facts and circumstances and concludes that the license of IP and services are not distinct and should be accounted for as a single performance obligation (see Section 10.2.2). Company A concludes that a significant financing component does not exist because Customer B dictates when Company A provides the services (see Section 7.4.1).

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While control of the license of IP transfers to Customer B upfront, the license does not represent a performance obligation in-and-of-itself. The license of IP is combined with the services to arrive at the only performance obligation in the contract. As a result, the nonrefundable upfront fee represents an advance payment for the performance obligation and is recognized as revenue when (or as) that performance obligation is satisfied.



Spotlight on change

Under SAB Topic 13 in legacy GAAP, nonrefundable upfront fees that do not relate to goods or services transferred to a customer upfront (e.g., initiation or setup fees) generally were recognized as revenue on a straight-line basis over the longer of the contract term or expected customer life. Under ASC 606, the timing of when a nonrefundable upfront fee should be recognized (whether upfront or otherwise) depends on the nature of the performance obligations in the contract. When a nonrefundable upfront fee is recognized as revenue over time under ASC 606, the period over which it is recognized only will exceed the contract term (see Section 5.3) if there is a contract renewal option that is a performance obligation because it provides the customer with a material right that it would not have received if it had not entered into the contract with the entity. Otherwise, the period over which the nonrefundable upfront fee is recognized as revenue over time under ASC 606 will be no more than the contract term. As a result, there could be situations where a nonrefundable upfront fee was recognized as revenue over the expected life of the customer under legacy GAAP but is recognized as revenue over the contract term under ASC 606. In these situations, the nonrefundable upfront fee would be recognized earlier under ASC 606 than under SAB Topic 13.

For instance, consider Example 7-1. In that example, the customer pays a $50 nonrefundable upfront activation fee. The following table summarizes the accounting for that fee depending on whether payment of that fee provides the customer with a material right related to contract renewal that it would not have received without entering into the contract with the entity:

	Does payment of the nonrefundable upfront activation fee provide the customer with a material right related to contract renewal that the customer would not have received if it had not entered into the contract with the entity?	
	Yes	**No**
ASC 606	The activation fee should be recognized over the period the customer is expected to benefit from paying the activation fee, which may not necessarily be the two-year average customer life.	The activation fee should be recognized over the one-month contract term.
Legacy GAAP	The activation fee should be recognized over the average customer life of two years.	The activation fee should be recognized over the average customer life of two years.

This example illustrates two important points: (a) the difference in how nonrefundable upfront fees in certain facts and circumstances may be accounted for under ASC 606 compared to legacy GAAP and (b) the importance under ASC 606 of understanding whether the payment of a nonrefundable upfront fee provides the customer with a material right related to contract renewal that it would have not received without entering into the contract with the entity.

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7.2 Noncash consideration

At contract inception, if the fair value of noncash consideration can be reasonably estimated, then that fair value is included in the transaction price. Otherwise, the entity should indirectly determine its fair value using the standalone selling prices of the goods or services being provided to the customer and include that amount in the transaction price.

After contract inception, the fair value of the noncash consideration may vary due to its form (e.g., a share of the customer's stock) or for other reasons (e.g., the entity's performance). Variations in fair value after contract inception that are due to the form of the noncash consideration are not reflected in the transaction price. Variations in fair value after contract inception that are not due to the form of the noncash consideration should be accounted for using the variable consideration guidance in ASC 606 (see Section 7.3). If variations in the fair value after contract inception are caused by both the form of the noncash consideration and other factors not related to the form of the noncash consideration, then only the portion of the variability attributable to factors other than the form of the noncash consideration should be accounted for using the variable consideration guidance in ASC 606. The portion of the variability attributable to the form of the noncash consideration is excluded from the transaction price, and therefore, from revenue.

If applying ASC 606 results in the entity recognizing a receivable or contract asset for the noncash consideration, and the fair value of the consideration varies due to its form, the entity would need to assess the contract asset or receivable for impairment after contract inception and before the noncash consideration is received.

A customer may provide noncash consideration to the entity in the form of contributed goods or services the entity will use in fulfilling its obligations to the customer. In that situation, the question arises as to whether the entity should reflect the fair value of those contributed goods or services in the transaction price. The answer to that question depends on whether the entity obtains control of those goods or services. If it does, then their fair value is included in the transaction price. If it does not, then their fair value is not included in the transaction price.



Example 7-4: Determining the transaction price when the noncash consideration is shares of the customer's stock (ASC 606-10-55-248 to 55-250)

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).

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.

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.

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RSM COMMENTARY: Because the fair value of the customer's stock varies due to its form, the amount of variable consideration included in the transaction price does not change after inception of the contract even if the fair value of the customer's stock changes. Assume the following additional facts:

- At contract inception, the fair value of the customer's stock was $100 per share.
- Upon the customer transferring the first 100 shares of its stock to the entity after the entity successfully completed the first week of service, the fair value of the customer's stock had risen to $110.
- The customer's stock has a readily determinable fair value.

The transaction price for the contract is $520,000 (5,200 shares × $100 per share). As a result, Company A will recognize $10,000 of revenue as each week of service is provided. Company A makes the following journal entry for transferring control of the first week of services:

	Debit	Credit
Investment in equity securities	$11,000	
Revenue		$10,000
Gain on investment in equity securities		1,000

If the price had fallen to $90 upon the customer transferring the first 100 shares of its stock to the entity after the entity successfully completed the first week of service, the entity would still recognize $10,000 of revenue. However, instead of recognizing an investment in equity securities of $11,000 and a gain on that investment of $1,000, the entity would recognize an investment in equity securities of $9,000 and a loss on that investment of $1,000.



Example 7-5: Determining the transaction price when the fair value of the noncash consideration varies due to its form and the entity's performance

Company A enters into a contract with Customer B on October 28, 20X1 to build a new facility for Customer B. If Company A completes the facility within six months, Customer B will transfer 10,000 shares of its common stock. If Company A completes the facility after six months, Customer B will transfer 9,000 shares of its common stock. The fair value of Customer B's common stock is $100 per share at contract inception and Company A believes it is probable that it will complete the facility within six months. Company A also concludes the contract includes one performance obligation satisfied over time under ASC 606 (see Section 9.3). Company A will measure its progress toward completing the one performance obligation using a cost-to-cost method (see Section 9.3.2). Company A estimates the total costs of constructing the facility to be $600,000. Company A has a calendar year end and does not prepare interim financial statements.

Company A applies the variable consideration model in ASC 606 to determine the transaction price at contract inception. Company A decides to use the most likely amount method to estimate the amount to which it expects to be entitled (see Section 7.3.2), which results in that amount being $1 million. Because Company A concludes (and can support that) it is probable that it will complete the facility within six months, application of the variable consideration constraint (see Section 7.3.3) results in Company A concluding that the transaction price is $1 million.

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On December 31, 20X1, Company A has incurred $180,000 in costs to construct the facility. In addition, Company A still believes it is probable that it will complete the facility within six months. Neither the fair value of Customer B's common stock nor the estimated total costs have changed since October 28, 20X1.

Company A records the following revenue-related journal entry as of December 31, 20X1:

	Debit	Credit
Contract asset	$300,000	
Revenue ($1,000,000 × [$180,000 ÷ $600,000])		$300,000

Company A does not finish the facility until May 15, 20X2. As a result, Customer B transfers 9,000 shares of its common stock to Company A upon completion of the facility. The fair value of Customer B's common stock is $105 per share on May 15, 20X2. Company A concludes there is a change in the transaction price related to it failing to complete the facility within six months. The revised transaction price is $900,000 (9,000 shares of Customer B's common stock received as a result of completing the facility more than six months after contract inception × $100 per share fair value of Customer B's common stock at contract inception). The change in the fair value of the noncash consideration resulting from the increase in the fair value of Customer B's common stock is not reflected in the transaction price because that variability is due to its form (i.e., common stock). As a result, Company A records the following revenue-related journal entry related to its completion of the facility and receipt of 9,000 shares of Customer B's stock.

	Debit	Credit
Investment in equity securities (Note 1)	$945,000	
Revenue (Note 2)		$600,000
Contract asset		300,000
Gain on investment in equity securities (Note 3)		45,000

Note 1: 9,000 shares × $105 per share fair value

Note 2: $900,000 revised transaction price – $300,000 recognized as revenue through December 31, 20X1.

Note 3: 9,000 shares × $5 change in the fair value of Customer B's common stock from contract inception until completion of the facility

7.3 Variable consideration

7.3.1 General requirements

Variable consideration can take many forms—refunds, returns, discounts, rebates, performance bonuses, milestone payments, penalties, contract claims and price concessions, just to name a few. The variability in the amount of consideration payable by the customer may be stated in the contract, or it may be caused by an implicit price concession that the entity intends to offer the customer or that the customer has a valid expectation of receiving based on the entity's customary business practices, published policies or specific statements (e.g., the discount from standard rates that a hospital intends to offer a self-pay patient). The variability in the consideration could affect whether the entity is entitled to the consideration (e.g., achieving or not achieving a deadline to which a performance bonus is tied) and (or) the specific amount of consideration the customer ultimately will have to pay (e.g., the performance bonus to which an entity will be entitled depends on how early it is able to complete the project).

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There are certain scenarios in which an entity may not be required to estimate variable consideration as follows:

- An entity provides a series of distinct good or services for which the variable payments relate specifically to the entity's efforts to transfer each *distinct* good or service within the series (see Section 8.3.2.1)
- An entity is entitled to sales- or usage-based royalties and the only, or predominant, item(s) to which the royalty relates is the license of IP (see Section 7.3.5)
- An entity elects to apply the practical expedient that allows revenue to be recognized for the amount the entity has a right to invoice (see Section 9.3.1.1)

In all other scenarios, an estimate of the variable consideration to which the entity expects to be entitled should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. This approach to determining the amount of variable consideration that should be included in the transaction price suggests there are two distinct steps an entity should perform:

1. Estimate the amount of variable consideration to which the entity expects to be entitled
2. Constrain the estimated amount of variable consideration such that it is probable that the inclusion of the estimate in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved

While determining the amount of variable consideration that should be included in the transaction price should most often be determined by applying these two steps, the FASB pointed out in paragraph BC215 of ASU 2014-09 that ASC 606 does not necessarily require an entity to perform two distinct steps:

> Although some respondents explained that they reasoned that this guidance would inappropriately require a two-step process, the Boards observed that an entity would not be required to strictly follow those two steps if the entity's process for estimating variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based. For example, an entity might estimate revenue from sales of goods with a right of return. In that case, the entity might not practically need to estimate the expected revenue and then apply the constraint guidance to that estimate, if the entity's calculation of the estimated revenue incorporates the entity's expectations of returns at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal.

Determining whether the entity's process for estimating "variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based" will require significant judgment to be exercised and careful consideration of all the facts and circumstances.



Example 7-6: Identifying variable consideration in a contract with a penalty (ASC 606-10-55-194 to 55-196)

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.

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).

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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7Q.3.1.1 How should an entity determine whether variable attributes in a contract give rise to variable consideration or an option for additional goods or services?

Consider situations such as those in which the customer of a mobile telecommunications company may choose to purchase additional monthly call minutes or text messages, or the customer of a transaction processor is invoiced based on the number of transactions processed in each month. There is a variable attribute in each of these situations—volume of call minutes and text messages and number of transactions processed, respectively. In these and other situations in which a contract has variable attributes, determining whether those variable attributes give rise to variable consideration or an option for additional goods or services is important, given the differences in the accounting model for each—treatment as variable consideration results in accounting for the variability within the transaction price, while treatment as an option could result in the identification of an additional performance obligation.

In many cases, determining whether variable attributes in a contract give rise to variable consideration will be relatively straightforward. However, in other cases, it may not initially be clear whether the variable attributes in a contract give rise to variable consideration or an option for additional goods or services. Making this determination is discussed in detail in Section 6.6.1.



Spotlight on change

One of the criteria considered under certain legacy GAAP for purposes of revenue recognition was whether the fee is fixed or determinable. Application of this criterion and other specific guidance related to variable consideration resulted in the recognition of most variable consideration when the related contingency was resolved. While ASC 606 includes an overall constraint on the amount of variable consideration included in the transaction price, earlier recognition of variable consideration is still expected to occur in many cases under ASC 606 compared to certain legacy GAAP.

7.3.2 Estimating variable consideration

To determine the amount of variable consideration that should be included in the transaction price, typically the entity first estimates the amount to which it expects to be entitled using one of the following two methods:

- *Expected value method.* Under this method, the entity: (a) identifies a range of possible consideration amounts, (b) assigns a probability to each identified amount in the range based on the likelihood that amount will be the final consideration amount, (c) calculates the probability-weighted amount for each identified amount in the range and (d) totals those probability-weighted amounts to arrive at the estimate of variable consideration to which the entity expects to be entitled.
- *Most likely amount method*. Under this method, the entity identifies a range of possible consideration amounts and then identifies the amount within that range that will most likely be the final consideration amount.

The method an entity should use depends on which method will better predict the amount of variable consideration in the particular set of facts and circumstances. One method should be used consistently when accounting for a contract's variable payment stream. However, to the extent a contract includes two different variable payment streams based on the resolution of different uncertainties, the facts and circumstances may support using different methods to estimate the variable consideration expected upon the resolution of each uncertainty.

To illustrate the two methods that may be used to estimate the amount of variable consideration to which the entity expects to be entitled, and the difference between them, consider the following examples.

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Example 7-7: Illustrating how to estimate variable consideration using the expected value method and the most likely amount method

Company A enters into a contract to construct a building for Customer B. Company A commits to turning control of the building over to Customer B no later than June 30, 20X1. In return, Customer B agrees to pay $1 million for the building. To incent Company A to turn control of the building over to it sooner, Customer B agrees to pay Company A an additional $250,000 for each week before June 30, 20X1 that Company A turns control of the building over to Customer B. However, the total incentive payment cannot exceed $500,000. Company A assigns the following probabilities to Customer B owing $0, $250,000 or $500,000 in variable consideration, which results in the following estimates of variable consideration using the expected value method and most likely amount method:

Delivery occurs…	Incentive payment	Probability	Probability-weighted average
On June 30, 20X1 or less than one week before	$ -	20%	$ -
At least one week before, but less than two weeks before, June 30, 20X1	250,000	20%	50,000
Two weeks or more before June 30, 20X1	500,000	60%	300,000
Variable consideration estimated using the expected value method			350,000
Variable consideration estimated using the most likely amount method			500,000

Company A does not have a free choice with respect to using either the expected value method or most likely amount method. It must analyze all of its facts and circumstances and determine which method better predicts the amount of variable consideration in those facts and circumstances. Making this determination will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

Application of the variable consideration constraint to this example is discussed in Question 7Q.3.3.2.



Example 7-8: Estimating variable consideration for two different uncertainties in the same contract (ASC 606-10-55-197 to 55-200)

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.

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.

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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.

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.

7Q.3.2.1 What are the circumstances under which the expected value method should be used instead of the most likely amount method, and vice versa?

While ASC 606 indicates that the method an entity should use to estimate variable consideration is the one that will best predict the amount of variable consideration to which the entity expects to be entitled, it does not provide any hard-and-fast rules related to when the expected value method or most likely amount method would provide the best prediction. The closest ASC 606 comes to providing guidance on when one method should be used over another is by making the following two observations in ASC 606-10-32-8:

- "An expected value method may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics."
- "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)."

It is important to note use of the word *may* in both of these observations. In other words, an entity is not required to use the expected value method when it has a large number of similar contracts. Nor is an entity required to use the most likely amount method when the contract only has two possible outcomes.

Determining whether the expected value method or most likely amount method should be used to estimate the amount of variable consideration to which the entity expects to be entitled will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

7Q.3.2.2 How many possible consideration amounts does an entity have to identify for purposes of calculating an expected value or identifying the most likely amount?

The answer to this question depends on the facts and circumstances. In some situations, the terms of the contract will limit the number of possible consideration amounts. For example, in Example 7-7, the terms of the contract limit the number of possible consideration amounts to three. When there are numerous consideration amounts that could be paid out under a contract (such as any amount between $0 and $1 million), the entity should identify a reasonable number of possible consideration amounts. In other words, when there are numerous consideration amounts, the entity is not required to assign a probability to every possible amount. One or more of the following could help the entity identify a reasonable number of possible consideration amounts: (a) reviewing information used in the bid or proposal process, (b)

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analyzing the information used to set the price for the contract and (c) understanding the entity's history in similar situations.

7.3.3 Applying the variable consideration constraint

Once the entity has estimated the amount of variable consideration to which it expects to be entitled, it then needs to apply the constraint focused on whether it is probable that the inclusion of the estimated variable consideration in the transaction price will not result in a reversal of cumulative revenue recognized for the contract that is significant as compared to the transaction price, including both fixed and variable consideration, when the uncertainty giving rise to the variability is resolved. Only estimated variable consideration for which it is probable that its inclusion in the transaction price will not result in a significant reversal of cumulative revenue recognized should be included in the transaction price. If it is probable that a significant reversal of cumulative revenue recognized will not occur with respect to just a portion of the estimated variable consideration to which the entity expects to be entitled, that portion would be included in the transaction price.

The following are factors that may (depending on their likelihood and magnitude) increase the probability of the entity experiencing a significant reversal in cumulative revenue recognized upon resolution of the uncertainty giving rise to the variability in the amount the customer ultimately will be obligated to pay:

- The amount of consideration is highly susceptible to market volatility, the judgments or actions of others, weather conditions and (or) other factors outside the entity's control or influence.
- The amount of consideration is highly susceptible to the promised good or service becoming obsolete.
- The period of time until the uncertainty is resolved is long.
- The entity has limited experience with or information about similar contracts.
- The entity's experience with or information about similar contracts has limited predictive value.
- The entity has a history of offering a broad range of price concessions in similar situations.
- The entity has a history of changing payment terms or conditions in similar situations.
- The number of possible amounts the customer ultimately could be required to pay is large, and those amounts fall across a broad range.

The more of these factors that exist in a particular situation, the more likely it is that the entity's estimate of variable consideration should be constrained.

Determining whether the entity's estimate of variable consideration should be constrained will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

7Q.3.3.1 Should the constraint on variable consideration be applied at the contract level or performance obligation level?

This issue was addressed in Question 30 of the FASB RRI Q&As, and it was generally agreed that the constraint on variable consideration should be applied at the contract level. Due to that conclusion, for purposes of assessing whether a significant reversal of revenue will occur in the future (the constraint), an entity should consider the estimated transaction price of the contract rather than the amount allocated to an individual performance obligation.

7Q.3.3.2 Does the amount of variable consideration included in the transaction price have to be an amount that is both a possible and probable outcome?

Application of the expected value method to estimate the amount of variable consideration to which the entity expects to be entitled could result in calculating an amount of variable consideration that is not an

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amount the entity could actually be entitled to receive under the contract. In other words, the amount calculated using the expected value method might not be a possible outcome under the contract. Consider Example 7-7. If Company A decided in that example that the expected value method best predicts the amount of variable consideration to which it expects to be entitled in its facts and circumstances, it would estimate the amount of variable consideration as follows:

Delivery occurs…	Incentive payment	Probability	Probability-weighted average
On June 30, 20X1 or less than one week before	$ -	20%	$ -
At least one week before, but less than two weeks before, June 30, 20X1	250,000	20%	50,000
Two weeks or more before June 30, 20X1	500,000	60%	300,000
Variable consideration estimated using the expected value method			$350,000

The variable consideration constraint requires Company A to determine whether it is probable that including $350,000 in the transaction price will not result in a significant reversal of cumulative revenue recognized upon Company A completing the building. Because there is only a 60 percent chance (i.e., not probable) that Company A will be entitled to at least $350,000, some may conclude that the variable consideration should be constrained to $250,000 for which there is an 80 percent chance of Company A being entitled to at least that amount.

The FASB staff and TRG discussed whether variable consideration should be constrained to the highest amount that is both a possible and probable outcome. This issue was addressed in Question 40 of the FASB RRI Q&As, and the following is a summary of the views expressed by the FASB staff and TRG as captured in Question 40:

> A few TRG members thought that the transaction price must be a possible outcome in that specific contract (View A). However, most TRG members thought that the application of that view would not result in recognizing revenue in a manner that is consistent with the core principle of Topic 606. When an entity has concluded that the expected value approach is the appropriate method to estimate variable consideration, application of the constraint also is performed based on the expected value method (View B). That is, an entity is not required to switch from an expected value method to most likely amount for purposes of applying the constraint. As a result, if an entity applies the expected value method (and uses a portfolio of data in determining the expected value) for a particular contract, the estimated transaction price might not be a possible outcome in an individual contract. An entity must still consider the constraint on variable consideration. That is, in some cases, an entity might constrain an expected value estimate when determining the transaction price.

In addition, the following observations are made in paragraph 18 of TRG 38:

> …the staff observes that application of the expected value method, which requires an entity to consider probability-weighted amounts, is complementary in some ways to the objective underlying the constraint on variable consideration. In developing its estimate of the transaction price in accordance with the expected value method, the entity has reduced the probability of a revenue reversal and might not need to constrain its estimate of variable consideration.

Based on the discussions of the FASB staff and TRG, Company A is not *automatically* required to constrain the variable consideration included in the transaction price to $250,000 just because there is only a 60 percent chance (i.e., not probable) that it will be entitled to the $350,000 calculated using the expected value method. As a result, Company A should first determine whether the $100,000 reversal in cumulative revenue recognized that would be recorded if it included $350,000 in the transaction price when it ultimately only was entitled to $250,000 is significant. To do so, Company A measures the

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potential $100,000 reversal against the transaction price for the contract as a whole and not just the variable component of the transaction price. Given that $100,000 represents 8 percent of $1,250,000, Company A concludes a $100,000 reversal in cumulative revenue recognized would be significant. If $100,000 would not have represented a significant reversal in cumulative revenue recognized, Company A would not apply the constraint and would include $350,000 in the transaction price.

Because $100,000 would represent a significant reversal of cumulative revenue recognized, Company A should next determine whether it is probable that including $350,000 in the transaction price ultimately will not result in a $100,000 reversal of cumulative revenue recognized. To do so, Company A should consider the following questions:

- *Was a portfolio of data for similar situations used in applying the expected value method?* If so, that may be an indication that Company A should not constrain the $350,000 of variable consideration estimated using the expected value method.
- *To what extent are any of the factors discussed in Section 7.3.3 present in Company A's situation?* If none of the factors are present, that may be an indication that Company A should not constrain its $350,000 expected value estimate of variable consideration. If all of the factors are present, that may be a strong indication that Company A should constrain its estimate of variable consideration to $250,000.

Company A ultimately is trying to determine whether its use of the expected value method to estimate the variable consideration to which it expects to be entitled has reduced the probability of a revenue reversal such that it does not have to constrain its estimate of variable consideration. In other words, it is trying to determine whether the variable consideration constraint has been inherently considered in its use of the expected value method. Making this determination will require Company A to exercise significant judgment and carefully consider all its facts and circumstances.



Example 7-9: Applying the variable consideration constraint to an asset management fee and performance fee (ASC 606-10-55-221 to 55-225)

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.

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).

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.

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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.

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.



RSM COMMENTARY: Chapter 4 of the Revenue Recognition AAG addresses how to account for the following under ASC 606: (a) contingent deferred sales charges, (b) management fees, (c) incentive or performance fees, (d) incentive-based capital allocations and (e) management fee waivers and customer expense reimbursements.

7.3.4 Reassessing variable consideration

The estimate of variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. Any changes in the estimate of variable consideration are treated the same as any other changes in the transaction price (see Section 8.4). The method used to initially estimate the variable consideration included in the transaction price also should be used when the estimate is reassessed each reporting period. Examples related to reassessing variable consideration and accounting for any changes in the transaction price are included in Section 8.4.

7.3.5 Sales- and (or) usage-based royalty exception

The overall variable consideration guidance in ASC 606 should not be applied to a sales- and (or) usage-based royalty when the only, or predominant, item(s) to which the royalty relates is the license of IP. The royalties subject to this exception should not be included in the transaction price until the later of: (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation in whole or in part. It is important to note the following about this exception:

- It does not apply to outright sales of IP.
- It should not be applied to part of a royalty stream (i.e., it is applied on an all-or-nothing basis).
- It should not be applied by analogy to account for other types of variable consideration or other types of promised goods or services.

Sales- and (or) usage-based royalties that are not subject to this exception (e.g., a usage-based royalty that is not related to a license of IP) should be accounted for using the variable consideration guidance otherwise required by ASC 606.

As illustrated in Example 7-10, Example 7-12 and Example 8-6, there are situations in which the amount of sales- and (or) usage-based royalties to which the entity expects to be entitled will need to be estimated using either the expected value method or the most likely amount method even when the sales- and (or) usage-based royalty exception applies. The estimate may be needed in these situations

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because the royalty has to be allocated between multiple performance obligations or because the entity receives the sales data or usage data from its customer in arrears (see Question 7Q.3.5.3).



Example 7-10: Determining the predominant item to which a sales-based royalty relates and accounting for that royalty (ASC 606-10-55-393 to 55-394)

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).

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.



RSM COMMENTARY: Recognizing the sales-based royalty in accordance with paragraph 606-10-55-65 results in recognizing the royalty as revenue upon the later of: (a) the customer's movie sales occurring or (b) the related performance obligation being satisfied in whole or in part. Based on the guidance in Section 10.2.1, the movie license represents a right to use the movie for which revenue should be recognized at a point in time. Given that control of the movie has to pass to the customer before the customer can show the movie and generate sales, the sales-based royalties allocated to the movie license should be recognized upon the customer's sales occurring, which is after the movie license performance obligation is satisfied.

7Q.3.5.1 How does an entity know whether the predominant item to which a sales- and (or) usage-based royalty relates is the license of IP?

In a contract with just a license of IP and a sales- and (or) usage-based royalty, that royalty solely relates to that license, and the sales- and (or) usage-based royalty exception applies. In a contract with a license of IP and other promised goods or services, as well as a sales- and (or) usage-based royalty, the license of IP is the predominant item (and the sales- and [or] usage-based royalty exception applies) if the customer ascribes significantly more value to the license than it does to the other promised goods or services.



Example 7-11: Determining the predominant item in a franchise agreement to which a sales-based royalty relates and accounting for that royalty (ASC 606-10-55-375 to 55-382)

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

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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

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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.

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.



RSM COMMENTARY: Additional guidance related to this example is in Chapter 8 (allocating the transaction price) and Chapter 10 (accounting for licenses).

7Q.3.5.2 How does an entity know whether the sales- and (or) usage-based royalty exception applies when the contract includes two or more licenses of IP and other promised goods or services?

The licenses should be considered on an aggregate basis for purposes of identifying the predominant item to which the royalty relates. In other words, in a contract with two or more licenses of IP and other promised goods or services, the licenses of IP are the predominant item(s) (and the sales- and [or] usage-based royalty exception applies) if the customer ascribes significantly more value to those licenses in the aggregate than it does to the other promised goods or services.

7Q.3.5.3 Should an entity wait until it gets sales data from its customer to include a royalty based on those sales in the transaction price?

No. When the entity gets sales data from its customers has no bearing on when the entity includes royalties related to those sales in the transaction price. As discussed earlier, royalties subject to the sales- and (or) usage-based royalties exception should not be included in the transaction price until the later of: (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation in whole or in part. If the entity does not yet have the sales data from its customer upon the later of those two events happening, it should estimate the royalties to which it expects to be entitled for purposes of including them in the transaction price at that point in time. This answer is consistent with the views expressed by an SEC staff member in his Remarks before the 35th Annual SEC and Financial Reporting Institute Conference in 2016.

If there is a subsequent change to the entity's estimate of the royalties to which it expects to be entitled as a result of receiving the sales data from the customer, the entity should account for that change as it would account for any other change in the transaction price. Consider the following example.

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Example 7-12: Estimating a sales-based royalty before customer provides sales data

Company A licenses use of a patented drug compound to Customer B, and Customer B must pay Company A a royalty based on Customer B's sales of any prescription drugs that incorporate the licensed drug compound. Because the patented drug compound is functional IP, it would be considered a right to use IP for which revenue is recognized at the point in time control of the licensed patented drug compound transfers to Customer B (see Section 10.2.1). As a result, the royalties should not be included in the transaction price (and recognized as revenue) until Company B sells the prescription drugs as that is the later of the resolution of the related uncertainty (Customer B's sales) and the satisfaction of the related performance obligation (control of the IP transfers to the customer).

Customer B provides sales data to Company A on a quarterly basis, but two months in arrears. Company A must file its Form 10-Q with the SEC 40 days after its quarter end. Company A has a calendar year end and is in the process of preparing its June 30, 20X1 interim financial statements for inclusion in its second-quarter Form 10-Q.

Because the related performance obligation already has been satisfied, Company A should estimate and recognize in its June 30, 20X1 interim financial statements the sales-based royalties due from Customer B for its second-quarter sales of the prescription drugs because the uncertainty related to the royalty has been resolved. If, when Company A receives the sales data from Customer B, there is a subsequent change to the estimated sales-based royalties for the second quarter, Company A would account for that change in the third quarter as it would account for any other change in the transaction price.

7Q.3.5.4 How does a minimum guarantee impact the recognition of sales- and (or) usage-based royalties in an IP license arrangement?

A minimum guarantee renders a portion of the transaction price fixed, and therefore raises questions as to how the minimum amount would impact the application of the sales- or usage- based royalty exception, which applies only to variable consideration. This issue was addressed in Questions 59 and 60 of the FASB RRI Q&As, and the FASB staff and TRG noted that the impact of a minimum guarantee depends on the nature of the IP being licensed.

For functional IP, which is transferred at a point in time, the fixed portion of the transaction price (i.e., the minimum guarantee) is recognized when the entity transfers control of the license to the customer, regardless of when the customer is required to pay the minimum. Any royalties earned above the fixed minimum amount are recognized in accordance with the royalty exception.

For symbolic IP, which is transferred over time, the measure of progress used to recognize the minimum guarantee should meet the objective of depicting the entity's performance in transferring control of the goods or services to the customer. The TRG discussed what would be appropriate applications of this principle in Question 59 of the FASB RRI Q&As and generally agreed that the following three views could be acceptable approaches, depending upon the facts and circumstances:

- If the entity expects to exceed the minimum guarantee, recognize the royalties as the related sales occur
- Estimate the total transaction price (fixed and variable) and recognize revenue using an appropriate measure of progress, subject to the constraint
- Recognize the fixed portion of the transaction price (i.e., minimum guarantee) using an appropriate measure of progress and recognize royalties only when cumulative royalties exceed the minimum guarantee

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The TRG also acknowledged that there may be other acceptable approaches that were not discussed. The following example illustrates the application of these three approaches.



Example 7-13: Recognizing minimum guarantees (Question 59 of the FASB RRI Q&As)

An entity enters into a five-year arrangement to license a trademark. The trademark is determined to be symbolic intellectual property (IP). The license requires the customer to pay a sales-based royalty of 5% of the customer's gross sales associated with the trademark; however, the contract includes a guarantee that the entity will receive a minimum of $5 million for the entire five-year period.

The customer's actual gross sales associated with the trademark and the related royalties each year are as follows (this information, of course, is not known at the beginning of the contract):

Year 1 - $15 million (royalties equal $750,000)

Year 2 - $30 million (royalties equal $1.5 million)

Year 3 - $40 million (royalties equal $2 million)

Year 4 - $20 million (royalties equal $1 million)

Year 5 - $60 million (royalties equal $3 million)

Total royalties equal $8.25 million.

In applying the three approaches the TRG noted to this example, the pattern of revenue recognition would be as outlined below:

Approach 1:

Under this approach, the entity would recognize the royalties as the related sales occur. This would be appropriate because the entity expects to exceed the minimum guarantee, so the royalties due each period would correspond to the value of the entity's performance to date. If total royalties were not expected to exceed the minimum guarantee, the entity would not be permitted to apply this method as it would have to true up the minimum guarantee at the end of the contract because the pattern of revenue recognition would not correlate with the value to the customer of the entity's performance to date. Approach 1 would result in the following pattern of revenue recognition:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Royalties received	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	750	1,500	2,000	1,000	3,000	8,250
Cumulative revenue	750	2,250	4,250	5,250	8,250	

Approach 2:

Under this approach, the entity would estimate the total transaction price (including both fixed and variable consideration) and recognize revenue using an appropriate measure of progress subject to the royalties constraint. Because an element of the consideration is fixed, the entity may recognize revenue in advance of the royalty from the customer's subsequent sales; however, once the minimum guarantee is met and there is no longer fixed consideration, the remaining consideration is variable and the entity is precluded from recognizing revenue for sales-based royalties in advance of the underlying sales. As a result, in year 4, the entity's revenue would be constrained to $0.3 million because cumulative revenue is constrained to the $5.25 million that the entity has earned to date.

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Approach 2 would result in the following pattern of revenue recognition:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Royalties received	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	1,650	1,650	1,650	300	3,000	8,250
Cumulative revenue	1,650	3,300	4,950	5,250	8,250	

Approach 3:

Under the third approach, the entity would recognize the fixed portion of the transaction price (i.e., minimum guarantee of $5 million) using an appropriate measure of progress ($1 million per year assuming use of a time-elapsed measure of progress) and recognize variable consideration ($3.25 million) only when cumulative royalties exceed the minimum guarantee. As a result, the entity does not begin to recognize any variable consideration until the royalties received exceed $5 million minimum on a cumulative basis because the variable consideration is only the amount in excess of the minimum guarantee of $5 million. Approach 3 would result in the following pattern of revenue recognition:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Royalties received	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	1,000	1,000	1,000	1,250	4,000	8,250
Cumulative revenue	1,000	2,000	3,000	4,250	8,250	

7.3.6 Right of return or refund

A customer's right to return a product or receive a refund of fees for services is not considered a performance obligation. Instead, it is treated as variable consideration. As a result, when the entity recognizes revenue, it does so for the amount of the transaction price to which it expects to be entitled, limited to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur (i.e., the transaction price reflects expected returns and refunds). In assessing the probability of a significant reversal in the cumulative revenue recognized, an entity should take many factors into consideration, including its history with the same or similar return rights, relevant industry information and economic trends.

The entity recognizes a refund liability for the amount received or receivable to which it ultimately does not expect to be entitled as a result of the return or refund right (i.e., the amount it is expected to refund). In addition, for product sales, the entity also separately recognizes an asset representing the right to returned inventory and an adjustment to cost of sales for estimated returns. The asset for the right to returned inventory is measured by using the former carrying amount of the product reduced for the costs expected to be incurred to recover the product, which include any decrease in value of the returned product. The refund liability and asset for returned inventory should be separately recognized (i.e., they should not be netted against each other).

At the end of each reporting period, an entity should review its estimated returns and refunds compared to actual and determine whether any adjustments are needed to the refund liability, revenue, asset for returned inventory and (or) costs of goods sold related to products and services sold subject to a right of return or refund.

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This guidance does not apply to: (a) product exchanges, provided the products are of the same type, quality, condition and price (which have no accounting effect) or (b) product exchanges due to defects (which are accounted for as warranties [see Section 6.5]).



Example 7-14: Accounting for the right of return (ASC 606-10-55-202 to 55-207)

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.

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.

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.

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).

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.

Upon transfer of control of the 100 products, the entity does not recognize revenue for the 3 products that it expects to be returned. Consequently, in accordance with paragraphs 606-10-32-10 and 606-10-55-23, the entity recognizes the following:

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

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7Q.3.6.1 How is an entity's accounting policy affected by it having a stated return period that is shorter than the return period allowed in practice?

Based on the discussion in Section 7.1 and Section 7.3.1, the entity's accounting for the right of return should be based on the return period the entity intends to allow or the return period the customer expects based on the entity's customary business practices. Consider a situation in which an entity has a stated return period of 30 days but allows customers to make returns for a period of 90 days. In this situation, the entity's accounting for the right of return should reflect the 90-day return period allowed in practice and not the 30-day stated return period.

7Q.3.6.2 What if an entity is not able to reasonably estimate expected product returns?

ASC 606 does not require an entity to conclude that it can make reasonable estimates of its expected product returns. Instead, ASC 606 treats product returns as variable consideration, and as a result, an entity estimates the expected product returns and applies the variable consideration constraint to that estimate. This requires the entity to consider whether it is probable that such estimate will not result in a significant reversal of cumulative revenue recognized. When an entity is not able to reasonably estimate returns, it likely will be required to constrain the amount of variable consideration included in the transaction price by increasing the estimate of product returns so that it is able to conclude that it is probable that the amount of variable consideration included in the transaction price will not result in a significant reversal of cumulative revenue recognized. In extreme cases, such as Example 7-23, the inability to reasonably estimate the number of product returns may result in the entity fully constraining revenue (i.e., having a transaction price of zero). In Example 7-23, the transaction price is zero until the return right lapses because: (a) the product being sold subject to the right of return is new, (b) the entity has no relevant historical experience with product returns and (c) there is no relevant market evidence available to the entity.

7Q.3.6.3 How should an entity account for restocking fees and costs related to returned products?

When a product is returned, an entity may charge the customer a restocking fee and (or) incur restocking costs, such as the costs to repackage the returned product. The FASB staff and TRG discussed how to account for such fees and costs given that they were not explicitly addressed by ASC 606. This issue was addressed in Question 42 of the FASB RRI Q&As, and the FASB staff and TRG concluded that: (a) restocking fees related to the products expected to be returned should be included in the transaction price and recognized when control of the product is transferred to the customer and (b) restocking costs related to the products expected to be returned should be accrued and used to reduce the asset for returned inventory when control of the product is transferred to the customer. Consider the following example.



Example 7-15: Accounting for restocking fees and costs (Question 42 of the FASB RRI Q&As)

Entity enters into a contract with Customer to sell 10 widgets for $100 each. The cost of each widget is $75. Customer has the right to return a widget but will be charged a restocking fee of 10% (that is, $10 per widget). Entity expects to incur restocking costs of 5% (that is, $5 per widget). Entity concludes that, due to the existence of a return right, the consideration promised in its contract with Customer includes a variable amount. Entity uses the expected value method for estimating the variable consideration and estimates that 10% of widgets will be returned and that it is probable that returns will not exceed 10%. Entity expects that the returned widgets can be resold at a profit.

Entity would recognize revenue of $910 [(9 widgets expected not to be returned * $100 selling price) + (1 widget expected to be returned * $10 restocking fee)] and a refund liability of $90 [1 widget expected to be returned * ($100 selling price - $10 restocking fee)] when control of the widgets transfer to Customer.

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In addition, Question 77 of the FASB RRI Q&As indicates that the entity should accrue any expected restocking costs (and reduce the asset for returned inventory) on widgets expected to be returned when control of the widgets transfers to the customer.



RSM COMMENTARY: The entity records the following journal entry when control of the widgets transfers to the customer:

	Debit	Credit
Accounts receivable (Note 1)	$1,000	
Cost of goods sold (Note 2)	680	
Asset for returned inventory (Note 3)	70	
Revenue (Note 4)		$910
Refund liability (Note 5)		90
Inventory (Note 6)		750

Note 1: $100 price per widget × 10 widgets for which control transferred to the customer

Note 2: ($75 cost per widget × 10) – $70 asset for returned inventory (Note 3)

Note 3: $75 cost of the one widget expected to be returned – $5 restocking costs

Note 4: ($100 price per widget × 9 widgets expected to be sold and not returned) + $10 restocking fee for the one widget expected to be returned

Note 5: $100 price of the one widget expected to be returned – $10 restocking fee for the one widget expected to be returned

Note 6: $675 cost of the nine widgets sold and not expected to be returned + $75 cost of the one widget expected to be returned



Spotlight on change

As discussed in Question 7Q.3.6.2, ASC 606 does not require an entity to conclude that it can make reasonable estimates of its expected product returns to recognize revenue net of product returns. Instead, ASC 606 treats product returns as variable consideration, and as a result, an entity estimates the expected product returns and applies the variable consideration constraint to that estimate. Doing so will likely result in the entity recognizing revenue net of estimated product returns. In other words, it will be uncommon for the entity to estimate returns as 100 percent of the sales subject to the right of return. Conversely, under legacy GAAP, several criteria were required to be met to recognize revenue net of estimated product returns, one of which required the amount of expected returns to be reasonably estimable. As a result, if an entity was not able to reasonably estimate its expected product returns, under legacy GAAP it did not recognize any revenue for sales of the product sold subject to the right of return until the return right has substantially expired or until it was able to make reasonable estimates of the product returns (provided the other required criteria also are met). This difference between ASC 606 and legacy GAAP could result in earlier revenue recognition under ASC 606 in situations where returns could not be reasonably estimated (e.g., rollout of a new and radically different product sold subject to a right of return).

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7.3.7 Volume and early payment discounts and rebates

Discounts and other contract terms that are fixed at contract inception do not give rise to variable consideration. For example, if the contract terms indicate that the customer is receiving a five percent discount off list price for the equipment purchased, that discount is fixed. In contrast, if the contract terms indicate any of the following, the consideration is variable:

- The customer will receive a five percent discount off list price *if* the customer pays the amount owed within 30 days (early payment discount).
- The customer will receive a ten percent discount off list price *if* the customer buys more than a specified amount of consumer products (retrospective volume discount).
- The customer will receive a rebate of $10,000 *if* the customer purchases a certain quantity of consumer products (volume rebate).

The consideration is variable in these situations because it is uncertain whether the entity will have to provide the discount or rebate given that it is contingent on an action (or inaction) by the customer.

The following examples illustrate the application of the variable consideration guidance to common retrospective volume discount and rebate scenarios.



Example 7-16: Applying the variable consideration constraint to a retrospective volume discount (ASC 606-10-55-216 to 55-220)

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.

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.

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.

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.

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).

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RSM COMMENTARY: The fixed price of Product A is $90 per unit, and there is variable consideration of $10 per unit. The uncertainty related to the variable consideration is whether the customer will buy more than 1,000 units of Product A. The entity determined that the transaction price per unit for the customer's purchases in the first quarter ended March 31, 20X8 was $100 per unit (i.e., the variable consideration of $10 per unit was not constrained based on the entity's analysis of the facts and circumstances at that point in time). In the second quarter ended June 30, 20X8, the entity reassesses the variable consideration and concludes it should be constrained because of a change in the facts and circumstances (i.e., the customer's acquisition of another company and the increase in the relative quantity of Product A purchased by the customer in that quarter). Accounting for the change in the transaction price results in the entity making an adjustment to reduce revenue by $750 (75 units sold in the first quarter × $10 per unit) in the second quarter for the units of Product A transferred to the customer in the first quarter for which revenue was recognized at $100 per unit. Also in the second quarter, the entity recognizes revenue of $45,000 (500 units sold in the second quarter × $90 per unit).

Consider a change to the fact pattern in this example that would result in a reduction to the unit price for Product A from $100 to $90 if the customer paid for all shipments of Product A under the contract within 25 days of receipt. In this revised fact pattern, the entity would need to assess the likelihood of the customer making all payments for Product A over the contract term within the 25-day discount period (instead of assessing whether the customer would buy more than 1,000 units of Product A over the contract term). If the entity concluded in the first quarter that the customer would not make all payments for Product A within the 25-day discount period but reassessed its conclusion in the second quarter and concluded that the customer would make all payments for Product A within the 25-day discount period, the accounting for the early payment discount would produce the same accounting results as the volume discount in the preceding example. If the early payment discount applied to each shipment of Product A (instead of all shipments of Product A), the accounting results may differ depending on the entity's assessment of the likelihood of the customer paying for some shipments of Product A within the 25-day discount period and others outside the 25-day discount period.

Consider a different change to the fact pattern in this example that would result in the entity receiving a $10,000 rebate if the customer purchases more than 1,000 units. While the entity's accounting in the first quarter would remain the same in this revised fact pattern, its accounting in the second quarter would depend, at least in part, on how many units it expects the customer to purchase. For example, if the entity believes it is probable that the customer will purchase 1,200 units over the contract term, then the per unit price of $91.68 ([(1,200 units × $100 per unit) – $10,000 rebate] ÷ 1,200 units) would be used to calculate the adjustment to the revenue recognized in the first quarter and to calculate the revenue that would be recognized in the second quarter provided the variable consideration of $1.68 included in that per unit price would not otherwise need to be constrained.

Accounting for variable consideration often will require significant judgment to be exercised and careful consideration of an entity's own relevant facts and circumstances. It is critically important for an entity to exercise consistent judgment in similar facts and circumstances.

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Example 7-17: Estimating variable consideration when rebates are provided based on volume of customer purchases

CP Company (CPCo) enters into a master services agreement (MSA) with Retailer (CPCo's customer) to supply up to 50,000 dress shirts made out of a new stain-resistant fabric for $20 per shirt. To provide an incentive for Retailer to purchase a significant number of the new shirts, CPCo notifies Retailer that if sales volumes under the MSA exceed 40,000 dress shirts, CPCo will credit an agreed-upon percentage of gross sales (not to exceed 50,000 shirts) back to Retailer via a rebate.

CPCo decides to estimate the variable consideration that should be included in the transaction price for each dress shirt sold under the MSA using the expected value method. Provided in the following table are the rebate thresholds in the MSA, which are based on a 40,000-dress shirt benchmark, and the rebate earned on gross sales by Retailer if it reaches a specific rebate threshold. Also provided in the following table is CPCo's expectation with respect to the probability of Retailer meeting a particular rebate threshold. These probabilities are based on CPCo's analysis of a variety of factors, including Retailer's historical purchasing patterns and market expectations in Retailer's operating territory.

Rebate threshold with a 40,000-shirt benchmark	Rebate earned on gross sales when rebate threshold is met	Probability of meeting rebate threshold	Expected value of the rebate
40,000 or fewer	0.0%	10%	0.00%
40,001 to 45,000	1.0%	50%	0.50%
45,001 to 50,000	2.0%	40%	0.80%
			1.30% (or $0.26 per shirt)

Based on this information, CPCo will never be entitled to less than $19.60 ($20 × [1 – 2.0%]) per dress shirt sold to Retailer. As a result, the amount of variable consideration per dress shirt is $0.40 ($20 – $19.60). Based on applying the expected value method to estimate the rebate to which CPCo expects Retailer to be entitled, CPCo estimates that it expects to be entitled to approximately $0.14 of the variable consideration per dress shirt ($0.40 – [$0.40 × (1.3% ÷ 2.0%)]), for a net sales price per shirt of $19.74 ([$19.60 + $0.14] or [$20 × (1 – 1.3%)]).

If CPCo concludes that its use of the expected value method to estimate the variable consideration to which it expects to be entitled reduces the probability of a revenue reversal such that CPCo does not have to separately constrain its estimate of variable consideration, then the transaction price per dress shirt is $19.74. Otherwise, CPCo must consider whether it is probable that including $0.14 per dress shirt in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved. If it is probable, the transaction price per dress shirt is $19.74. If it is not probable, CPCo must determine the amount by which it should constrain the variable consideration of $0.14 for purposes of estimating the transaction price.

After Retailer issues its first purchase order for the dress shirts, CPCo must determine whether Retailer's option to buy additional shirts subject to the rebate represents a material right that Retailer would not have received had it not entered into the MSA with CPCo. Making this determination and the related accounting effects are discussed in Section 6.6.1 and Section 6.6.3, respectively.

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7.3.8 Price concessions

Price concessions arise when an entity provides its customer with a reduction in the price for some or all of the promised goods or services included in the customer contract. Because it is not uncommon for price concessions to be implicit at contract inception and only explicitly granted to a customer after contract inception, entities should ensure they have appropriate processes in place to identify implicit price concessions the entity intends to offer the customer, as well as those price concessions the customer has a valid expectation of receiving based on the entity's customary business practices, published policies or specific statements.

From an accounting perspective, price concessions are another form of variable consideration to which the variable consideration accounting model should be applied. Consider the following example.



Example 7-18: Applying the variable consideration constraint to price concessions (ASC 606-10-55-208 to 55-215)

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.

On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A—Estimate of Variable Consideration Is Not Constrained

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.

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).

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

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

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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.

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).

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.



RSM COMMENTARY: Following is a table that includes the factors discussed in Section 7.3.3 and an indication as to whether the factor is present in Case A and (or) Case B. After evaluating each of the factors in the context of Case A and Case B, it is clear why the variable consideration was not constrained in Case A, but was constrained in Case B.

	Factor present in…	
Factor	**Case A**	**Case B**
The amount of consideration is highly susceptible to market volatility, the judgments or actions of others, weather conditions and (or) other factors outside the entity's control or influence.	There is some uncertainty caused by factors outside the entity's influence.	Yes. Current market information suggests a broad range of price concessions (a 15 to 50 percent reduction in price) may be necessary to move the products through the distribution chain.
The amount of consideration is highly susceptible to the promised good or service becoming obsolete.	This factor is not addressed in the case facts.	Yes. The products have a high risk of obsolescence.

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	Factor present in…	
Factor	**Case A**	**Case B**
The period of time until the uncertainty is resolved is long.	No. The uncertainty is expected to be resolved in 90 days.	No. The uncertainty is expected to be resolved in 90 days.
The entity has limited experience with or information about similar contracts.	No. The entity has significant previous experience with price concessions on this product.	No. The entity has experience selling similar products.
The entity's experience with or information about similar contracts has limited predictive value.	No. The entity's historic information and current market data both suggest the same concession.	Yes. The entity is experiencing high volatility in pricing its products.
The entity has a history of offering a broad range of price concessions in similar situations.	No. The entity has not granted a concession significantly greater than 20 percent of the sales price in many years.	Yes. Historically, the entity has granted a broad range of price concessions ranging from 20 to 60 percent of the sales price for similar products.
The entity has a history of changing payment terms or conditions in similar situations.	No. The entity has not granted a concession significantly greater than 20 percent of the sales price in many years.	This factor is not addressed in the case facts.
The number of possible amounts the customer ultimately could be required to pay is large, and those amounts fall across a broad range.	No. The entity has not granted a concession significantly greater than 20 percent of the sales price in many years.	Yes. It is likely the entity will have to provide a broad range of price concessions to move the products through the distribution chain.

The following are additional assumptions related to the fact pattern in Case A and the corresponding journal entries:

- The inventory cost of the 1,000 products transferred by the entity to its customer is $55,000 and control of the products transfers to the entity's customer on December 1, 20X7. Based on these assumptions, the entity records the following journal entry:

	Case A	
	Debit	**Credit**
Contract asset	$80,000	
Cost of goods sold	55,000	
Revenue		$80,000
Inventory		55,000

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- The entity's customer sells 600 products to end customers in the first 30 days after having obtained control of the products. Based on this assumption, the entity records the following journal entry:

	Case A	
	Debit	**Credit**
Accounts receivable	$48,000	
Contract asset		$48,000

- Shortly after the end customers obtained control of the 600 products sold to them by the entity's customer, the entity explicitly grants a 20 percent discount to its customer on all 1,000 products transferred and does not expect to offer any additional discount. Based on this assumption, the entity does not record any further journal entries related to the 600 products over which the customer already has control because the 20 percent discount explicitly granted to the customer is the same as the concession used for purposes of measuring variable consideration and determining the transaction price.

The entity's customer sells the remaining 400 products to end customers in the second 30 days after having obtained control of the products. Based on this assumption, the entity records the following journal entry:

	Case A	
	Debit	**Credit**
Accounts receivable	$32,000	
Contract asset		$32,000

The following are additional assumptions related to the fact pattern in Case B and the corresponding journal entries:

- The inventory cost of the 1,000 products transferred by the entity to its customer is $55,000 and control of the products transfers to the entity's customer on December 1, 20X7. Based on these assumptions, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Contract asset	$50,000	
Cost of goods sold	55,000	
Revenue		$50,000
Inventory		55,000

- The entity's customer sells 900 products to end customers by January 31, 20X8. Based on this assumption, the entity records the following journal entry:

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	Case B	
	Debit	**Credit**
Accounts receivable	$45,000	
Contract asset		$45,000

- The entity receives a payment of $30,000 from its customer on January 31, 20X8. Based on this assumption, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Cash	$30,000	
Accounts receivable		$30,000

- The entity determines on January 31, 20X8 that it will grant a 40 percent discount to its customer in January 20X8 on all 1,000 products transferred and does not expect to offer any additional discount. Based on this assumption, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Accounts receivable (Note 1)	$9,000	
Contract asset (Note 2)	1,000	
Revenue (Note 3)		$10,000

Note 1: ([900 products sold to end customers × ($100 per product × [1 – 40%])] – $30,000) = $24,000, which is what the balance in Accounts receivable should be on January 31, 20X8. Compared to the actual balance of $15,000 ($45,000 – $30,000), Accounts receivable should be increased by $9,000 ($24,000 – $15,000).

Note 2: (100 products not yet sold to end customers x [$100 per product × (1 – 40%)]) = $6,000, which is what the balance in the Contract asset should be on January 31, 20X8. Compared to the actual balance of $5,000 ($50,000 – $45,000), the Contract asset should be increased by $1,000.

Note 3: ([1,000 products transferred to customer × ($100 per product × [1 – 40%])] – $50,000) = $10,000, which is the amount of additional revenue that should be recorded based on the actual discount of 40% compared to the constrained discount of 50%.

- In February 20X8, the entity explicitly grants the 40% discount to its customers, and the entity's customer sells the remaining 100 products to end customers. Based on these assumptions, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Accounts receivable	$6,000	
Contract asset		$6,000

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7.3.9 Unfunded or partially funded contracts

Because of the federal government's budgeting process, it is common for the government to enter into long-term contracts that are only partially funded. In such instances, the entity contracting with the federal government will first need to evaluate whether a contract exists for both the funded and unfunded portions of the contract (See Question 5Q.2.2).

If the entity determines that both the funded and unfunded portions of the contract meet the contract existence criteria, the unfunded portion should be considered variable consideration. The entity will therefore need to estimate the amount of consideration to which it will be entitled, assuming that all goods and services will be transferred to the customer in accordance with the contract terms. It will then need to constrain that amount and recognize revenue only to the extent that it is probable that a significant reversal of revenue will not occur. As part of this estimation process, the entity should assess the likelihood that the unfunded portion will be funded, which includes considering the following factors suggested in paragraph 3.1.14 of the Revenue Recognition AAG:

- Whether there is a short period of time before contract funding is expected
- Whether the work is sole source, a follow-on effort, or there is high competition
- Whether customer funding and budget exist and the task of processing the funding is administrative only
- Whether it is a major program or the customer is in critical need of the program
- Whether there has been communication from the customer that funding will be obtained
- Whether the entity has a history of receiving funding in similar situations

An entity is required to update its estimates of incentives and penalties on an ongoing basis, even if the beginning estimate is zero.



Example 7-19: Evaluating unfunded portions of a contract (Revenue Recognition AAG, Example 3-1-1)

On September 1, 20X1, an aerospace and defense contractor signed a contract with the U.S. federal government for a fixed price of $600 million over a three-year period of performance. The program will receive annual funding of $200 million, starting on September 30, 20X1. The entity concludes that the entire $600 million contract is within the scope of the revenue standard because the entity has an approved contract in writing signed by both parties, it clearly identifies each party's rights regarding goods and services to be delivered, the payment terms are clearly identified, and collectibility is probable because the customer has both ability and intent to pay.

On August 1, 20X2, the entity has recognized revenue of $200 million based on costs to date (plus a reasonable profit margin). In deciding whether to continue performing and recognizing revenue on the contract beyond funding, the entity analyzes the probability that it will receive funding and, therefore, not incur a significant reversal of cumulative revenue recognized. The entity considers the following factors:

- Time period before contract funding is expected is short (two months).
- Program is a follow-on contract.
- U.S. federal government has both the ability and intention to pay.
- U.S. federal government has a need for the program.
- Entity has received communication from the customer that funding will be obtained.

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- Historically, the entity was able to receive funding and recover its costs on contracts that led up to this follow-on work.

Based on these considerations, the entity concludes that the risk of a significant reversal of cumulative revenue is remote and, therefore, the unfunded amounts are included in the transaction price and recognized as revenue.



RSM COMMENTARY: In most cases, not all of the factors indicating whether the government will fund a contract will align, and the entity will need to exercise judgment in considering the importance of each factor. For example, assume all the same facts in this example except that the government has expressed uncertainty about the need for the program and the entity has not received communication from the customer that the funding will be obtained. In that scenario, the entity would likely conclude that it is not probable that a significant reversal of revenue will not occur if it includes the unfunded portion of the contract in the transaction price and would therefore need to constrain the transaction price and not recognize revenue for the unfunded portion of the contract. It would need to update its evaluation each period until the funding is provided or the contract is terminated.

7.3.10 Expense reimbursements

Some contracts require the customer to reimburse the entity for certain expenses it incurs in providing the customer with goods or services. When the entity is the principal in incurring these expenses (see Section 11.2), the reimbursements of those expenses should be included in the transaction price and reflected as revenue when recognized.

In most cases, the entity will seek reimbursement from the customer for the actual expenses incurred. Because the entity will not know the actual expenses to be reimbursed until they are incurred, the amount to which the entity expects to be entitled for those expense reimbursements is variable consideration. As a result, the entity must generally estimate the amount of reimbursements to which it expects to be entitled and include that amount in the transaction price at contract inception to the extent it is probable that doing so will not result in a significant reversal of cumulative revenue recognized when the entity actually incurs the reimbursable expenses (which is when the uncertainty would be resolved). However, as noted by the FASB Staff in Question 64 of the FASB RRI Q&As, there are several scenarios in which the application of the guidance in ASC 606 may not require estimating variable consideration related to reimbursements of out-of-pocket expenses:

(a) The entity is an agent as it relates to the specified good or service

(b) The variable consideration is constrained

(c) The variable consideration relates specifically to a performance obligation or a distinct good or service in a series

(d) The entity is able to apply the “as invoiced” practical expedient

(e) The entity applies a cost-to-cost measure of progress under existing GAAP and will provide a similar measure of progress under Topic 606.

If none of these items apply, the entity would be required to estimate reimbursements of out-of-pocket expenses as it does any other variable consideration included in the transaction price. To the extent there are any changes in the estimated expense reimbursements included in the transaction price, they are accounted for in the same manner as any other changes in the transaction price (see Section 8.4).

Reimbursable expenses are fulfillment costs that should be expensed as incurred unless they meet the criteria to be capitalized (see Section 13.1). Estimated expense reimbursements are part of the

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transaction price and will be recognized as revenue as otherwise required by ASC 606. As a result, the timing of when the reimbursable expenses are recognized and billed likely will not match when the expense reimbursements are recognized in revenue. Consider the following example.



Example 7-20: Including expense reimbursements in the transaction price

Company A enters into a contract with Customer B to provide three months of consulting services. The fee for providing these services is $210,000, and Customer B will reimburse Company A for travel expenses incurred in providing the consulting services. Company A is the principal with respect to incurring these expenses. Company A estimates that it will incur $15,000 of travel expenses over the three months it provides consulting services. For purposes of this example, assume that none of the scenarios discussed in PCC Memo No. 2 in which the application of the guidance in ASC 606 may not require estimating variable consideration related to reimbursements apply. Company A concludes that it is probable that including $15,000 in the transaction price will not result in a significant reversal in cumulative revenue recognized upon determining the actual amount of reimbursable costs. As such, the transaction price is $225,000.

Company A concludes there is one performance obligation (see Chapter 6), the performance obligation is satisfied over time (see Section 9.2) and an hours spent method will be used to measure its progress to complete satisfaction of the performance obligation (see Section 9.3.2). Company A expects to spend 1,500 hours providing the consulting services.

Company A begins providing the consulting services on March 1, 20X1. As of March 31, 20X1, Company A has spent 500 hours providing the consulting services. Company A still estimates that it will incur $15,000 of travel expenses over the three months it provides consulting services. As a result, the transaction price is still $225,000. In addition, Company A still estimates that it will spend 1,500 hours to provide the consulting services. Because Company A spent 500 hours in March, it concludes that $75,000 ($225,000 × 500 hours ÷ 1,500 hours) of the transaction price should be recognized as revenue in the month of March.

Note that Company A is: (a) recognizing revenue (and not a cost reduction) for the expense reimbursements because it is acting as a principal with respect to incurring those expenses, (b) recognizing the travel expenses as they are incurred, (c) determining the amount of revenue to recognize using an hours spent method and (d) not separately recognizing revenue for the expense reimbursements as it incurs or bills for those expenses.

7.3.11 Price matching and price protection

Some contracts include clauses in which the price paid by a customer for goods or services will be reduced retroactively if an entity's competitor sells the same goods or services at a lower price within a specified future time period ("price matching") or the entity itself sells the same goods or services to another customer at a lower price within a specified future time period ("price protection"). In both of these situations, the entity would be obligated to refund the excess amount charged to the customer for these goods or services or provide them a credit equal to this amount. These potential refunds and credits must be accounted for as variable consideration because it is uncertain whether the entity will have to provide the refund (and hence adjust the transaction price) on prior purchases given that it is contingent on a future pricing decision made by the entity or a competitor.

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7.4 Significant financing component

When a contract includes a significant implicit or explicit benefit of financing to either the entity or the customer (i.e., a significant financing component), that significant financing component is taken into consideration in determining the transaction price, unless an exception applies or the entity qualifies for and elects to apply a practical expedient. Reflecting a significant financing component in the transaction price incorporates the time value of money into the accounting for a contract. It is important to note that a financing component may exist in a contract when the payment terms provide for advance and (or) deferred payments. In other words, a financing component in a contract could result in the entity recognizing interest income or expense.



Spotlight on change

Under legacy GAAP, receivables for which the payment was not due for more than one year generally were discounted. However, the same is not true for advance payments, which ASC 606 requires to be accounted for as a significant financing component under certain circumstances. This could represent a significant change for entities that regularly receive long-term advance payments from their customers if those payments represent a significant financing component under ASC 606.

7.4.1 Determining whether a significant financing component exists

All the relevant facts and circumstances related to the contract should be considered in determining whether it includes a significant financing component, including the following:

- Whether there is a difference between the amount the customer would have had to (i.e., hypothetically) pay for the promised goods or services in cash upon their transfer and the amount the customer is paying for those goods or services based on the payment terms in the contract.
- The combined effect of: (a) the amount of time that will pass between when control of the promised goods or services is transferred to the customer and when customer payment is supposed to occur and (b) the relevant prevailing interest rates.

ASC 606 specifically indicates that a significant financing component does *not* exist in any of the following situations:

- The customer makes an advance payment and when the promised goods or services are transferred to the customer is at the customer's discretion (e.g., prepaid phone cards).
- There is substantial variable consideration, and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the entity's or customer's control (e.g., sales-based royalty).
- There are reasons not related to financing that justify the nature and amount of the difference between the cash selling price of the promised good or service and the promised consideration. For example: (a) deferred payment terms or contract holdbacks may protect the customer if the entity fails to satisfy some or all of its contractual obligations and (b) advance payments may secure for the customer a future supply of goods or services that are limited and (or) in high demand.

Determining whether a significant financing component exists in a contract requires exercising significant judgment and careful consideration of all the facts and circumstances. In her remarks at the 2018 AICPA Conference on Current SEC and PCAOB Developments, Sarah N. Esquivel, an Associate Chief Accountant in the SEC's Office of the Chief Accountant, provided an example of an entity receiving a large up-front payment for an IP license transferred over time and provided insight into the considerations that led to the entity's conclusion that the payment did not include a significant financing component. In

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arriving at this conclusion, the entity considered the following facts and circumstances as indicators that the up-front payment was for reasons other than providing financing:

- 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 marketplace, 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.

If, after careful consideration of the facts and circumstances, an entity determines that a contract has a significant financing component, a practical expedient to ignore that financing component when estimating the transaction price can be applied if the entity expects the difference between the following two events to be one year or less at contract inception: (a) the entity's transfer of the promised goods or services to the customer and (b) customer payment for those goods or services. When assessing whether the practical expedient can be applied, it is important to focus on these two events and not the duration of the contract in its totality.



Example 7-21: Determining whether holdbacks from milestone payments that coincide with the entity's performance give rise to a significant financing component (ASC 606-10-55-233 to 55-234)

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.

The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity's performance, and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 606-10-32-17(c). The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.



Example 7-22: Determining whether an advance payment for services transferred over a three-year period gives rise to a significant financing component (ASC 606-10-55-244 to 55-246)

An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional $300. Customers electing to buy this service must pay for it upfront (that is, a monthly payment option is not available).

To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to

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maximize profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

In assessing the guidance in paragraph 606-10-32-17(c), the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Unless otherwise noted, the following questions are based on discussions of the FASB staff and TRG as included in Questions 32 and 33 of the FASB RRI Q&As.

7Q.4.1.1 If the cash selling price and the promised consideration are equal, is that definitive evidence that a significant financing component does not exist?

No. The FASB staff and TRG concluded that determining whether there is a difference between the cash selling price and the promised consideration is only one indicator that should be considered by an entity when evaluating whether the contract includes a significant financing component. As a result, there being no difference between those amounts is only *indicative* (and not determinative) of a significant financing component not existing. When evaluating this indicator, the FASB staff and TRG also discussed the importance of the entity not assuming that the cash selling price is the same as the list price. Consider a situation in which an entity is running a promotion that allows customers to buy furniture at list price today (i.e., control of the furniture transfers to the customer today) and not pay for the furniture for two years. In this situation, the entity should understand whether a customer who buys the same furniture today also must pay the list price or whether that customer gets a discount. While determining whether there is a difference between the cash selling price and promised consideration is an important consideration in determining whether the contract in this situation includes a significant financing component, the entity also must consider other facts and circumstances relevant to the contract, including the combined effect of: (a) the amount of time that will pass between when control of the furniture is transferred to the customer (i.e., today) and when customer payment is supposed to occur (i.e., two years later) and (b) the relevant prevailing interest rates. Only after considering all the relevant facts and circumstances will the entity be in a position to exercise the judgment required to determine whether a significant financing component exists.

7Q.4.1.2 Is an entity precluded from reflecting a financing component in the transaction price that is not significant?

No. The FASB staff and TRG concluded that an entity is not precluded from reflecting a financing component in the transaction price that is not significant.

7.4.2 Reflecting the significant financing component in the transaction price

If an entity identifies a significant financing component in a contract, it must be taken into consideration in determining the transaction price unless an exception applies or the entity qualifies for and elects to apply the practical expedient. The objective of doing so is to recognize revenue in an amount consistent with what the customer would have paid in cash upon the transfer of the promised good or service. To adjust the promised consideration for the significant financing component, the entity should use a discount rate

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consistent with the rate that would be present in a separate financing transaction between the entity and the customer at contract inception. Such discount rate should take into consideration: (a) the credit risk of the entity (when advance payments are involved) or the customer (when deferred payments are involved) and (b) any collateral or other security provided by either party (which could be the assets subject to the contract). The discount rate is not adjusted after contract inception.

7.4.3 Subsequent accounting for the significant financing component

Interest income or expense should only be recognized to the extent an accounts receivable, contract asset or contract liability has been recognized for the contract. The relevant guidance in ASC 835-30 should be used to: (a) present any discount or premium in the financial statements and (b) account for the significant financing component using the interest method. The interest income (when there are deferred payments) or expense (when there are advance payments) that results from including the effects of a significant financing component in the transaction price should be presented separate from the transaction price attributed to the performance obligations (which is recognized as revenue). For example, a significant financing component that arises from an advance payment will result in the entity increasing the transaction price (which is the amount ultimately recognized as revenue) and recognizing interest expense on the income statement. These amounts cannot be netted against each other on the income statement.



Example 7-23: Identifying and accounting for a significant financing component (deferred payments) when a right of return also exists (ASC 606-10-55-227 to 55-232)

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.

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.

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.

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.

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:

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a. When the product is transferred to the customer, in accordance with paragraph 606-10-55-23.

Asset for right to recover product to be returned	$80 [a]	
Inventory		$80

(a) This Example does not consider expected costs to recover the asset.

b. During the three-month right of return period, no interest is recognized in accordance with paragraph 606-10-32-20 because no contract asset or receivable has been recognized.

c. When the right of return lapses (the product is not returned).

Receivable	$100 [b]	
Revenue		$100
Cost of sales	$80 [b]	
Asset for product to be returned		$80

(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.

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.



Example 7-24: Identifying and accounting for a significant financing component (deferred payments) when the contractual discount rate reflects a market rate (ASC 606-10-55-235 to 55-237)

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.

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).

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.



RSM COMMENTARY: The entity records the following revenue-related journal entry when control of the equipment transfers to the customer:

	Debit	Credit
Accounts receivable	$1,000,000	
Revenue		$1,000,000

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Upon the customer's first payment, the entity records the following journal entry:

	Debit	Credit
Cash	$18,871	
Accounts receivable (Note 1)		$14,704
Interest income (Note 2)		4,167

Note 1: $18,871 – $4,167 (Note 2) = $14,704

Note 2: $1,000,000 × 5% ÷ 12 months = $4,167



Example 7-25: Identifying and accounting for a significant financing component (deferred payments) when the contractual discount rate does not reflect a market rate (ASC 606-10-55-235 and 55-238 to 55-239)

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.

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.

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.

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RSM COMMENTARY: The entity records the following revenue-related journal entry when control of the equipment transfers to the customer:

	Debit	Credit
Accounts receivable	$848,357	
Revenue		$848,357

Upon the customer's first payment, the entity records the following journal entry:

	Debit	Credit
Cash	$18,871	
Accounts receivable (Note 1)		$10,387
Interest income (Note 2)		8,484

Note 1: $18,871 – $8,484 (Note 2) = $10,387

Note 2: $848,357 × 12% ÷ 12 months = $8,484



Example 7-26: Identifying and accounting for a significant financing component (advance payments) when the contractual discount rate does not reflect a market rate (ASC 606-10-55-240 to 55-243)

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.

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.

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.

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

a. Recognize a contract liability for the $4,000 payment received at contract inception.

Cash	$4,000	
Contract liability		$4,000

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b. During the 2 years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 606-10-32-20) and accretes the contract liability by recognizing interest on $4,000 at 6 percent for 2 years.

Interest expense	$494 [(a)]	
Contract liability		$494

(a) $494 = $4,000 contract liability × (6 percent interest per year for 2 years)

c. Recognize revenue for the transfer of the asset.

Contract liability	$4,494	
Revenue		$4,494

7Q.4.3.1 Is interest expense related to a significant financing component eligible for capitalization under ASC 835?

No, ASU 2020-10 clarified that interest expense related to a significant financing component is not within the scope of the interest capitalization guidance under ASC 835. As a result, an entity may not capitalize any interest related to a significant financing component.

7.5 Consideration payable to the customer

7.5.1 Identifying consideration payable to the customer

Consideration payable to the customer includes amounts the entity is explicitly required to pay to its customer (e.g., manufacturer paying a slotting fee to a retailer customer) or its customer's customers (e.g., manufacturer giving a rebate to a consumer [which is its customer's customer]). The consideration payable could be labeled a credit, coupon, voucher, rebate, cooperative advertising or slotting fee, among many others. 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). In addition, consideration payable to the customer may be implied based on an entity's past practices or the customer's expectations. An entity may or may not receive something in return for the consideration payable to the customer (e.g., manufacturer pays retailer customer for cooperative advertising or product placement at eye level).

Unless otherwise noted, the following questions are based on discussions of the FASB staff and TRG about consideration payable to a customer. These issues were addressed in Questions 25 and 26 of the FASB RRI Q&As.

7Q.5.1.1 Which payments to a customer (or a customer's customer) are treated as consideration payable to a customer for purposes of ASC 606?

The FASB staff and TRG concluded that consideration payable to the customer should include those payments to a customer that are either explicitly or implicitly part of the contract or a group of contracts combined based on the guidance in Section 5.4. In addition, the FASB staff and TRG concluded that an entity also should identify other payments that are linked to a contract. The following are two examples of such other payments:

- Payment to a customer in an amount that significantly exceeds the fair value of any goods or services received by the entity in exchange
- Payment to a customer within the distribution chain to facilitate movement of product through the chain

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For purposes of identifying other payments that are linked to a contract, the FASB staff and TRG do not believe this would require separate assessment and documentation of each payment made to a customer. Instead, the entity should approach identifying these other payments in the spirit of the core principle in ASC 606-10-10-2, 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."

7Q.5.1.2 Payments to which of the customers' customers should be treated as consideration payable to a customer for purposes of ASC 606?

The FASB staff and TRG concluded that payments to the customers' customers in the distribution chain should be treated as consideration payable to a customer for purposes of ASC 606. In addition, the FASB staff and TRG concluded that it might be appropriate, depending on the facts and circumstances, to treat payments to customers' customers outside the distribution chain as consideration payable to a customer for purposes of ASC 606. For example, if a payment to a customer's customer that is outside the distribution chain is required by the contract between the entity and its customer, the payment to the customer's customer that is outside the distribution chain should be treated as consideration payable to a customer for purposes of ASC 606. Other examples may involve situations in which an entity is acting as an agent for another party to provide goods or services to that other party's customers. For example, consider a situation in which a marketing agent works with a restaurant to arrange to have vouchers to that restaurant purchased by and delivered to the end customer. In this and similar situations, it might be appropriate, depending on the facts and circumstances, to treat payments to the other party's customers (e.g., the end customer), in addition to payments to the other party (e.g., the restaurant), as consideration payable to the customer for purposes of ASC 606. When identifying the payments to customers' customers outside the distribution chain that should be treated as consideration payable to a customer for purposes of ASC 606, an entity should do so in the spirit of the core principle in ASC 606-10-10-2, 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."

7Q.5.1.3 Could payments to a party other than a customer be treated as consideration payable to a customer for purposes of ASC 606?

Yes. The counterparty to a payment (whether a customer, customer's customer or third party) would not be determinative in considering whether the payment is consideration payable to a customer for purposes of ASC 606. Therefore, while payments are often made to a customer directly, there may be circumstances in which payments are provided to the customer's customers or third parties on behalf of customers. For example, an entity may make a payment directly to a third party, such as an interest rate buydown to a third-party lender, to incentivize the customer to obtain the entity's product through the provision of a more favorable interest rate by the third party to the customer.

Determining if a payment to a third party should be treated as consideration payable to a customer requires evaluating the nature of the payment to see if, in substance, the payment is for the benefit of the customer and linked to the contract. If it is determined that the payment is for the benefit of the customer, the entity needs to consider whether it receives a distinct good or service from the third party. If the entity does not receive a distinct good or service from the third party, the payment to the third party should be treated as consideration payable to a customer and treated as reduction in transaction price of the contract with the customer. If the entity does receive a distinct good or service from the third party, and provides that good or service to the customer, it would generally be treated as a cost to fulfill the contract and classified within cost of sales.

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7.5.2 Accounting for consideration payable to a customer

Consideration payable to a customer is reflected as a reduction of the transaction price (and, as a result, a reduction of revenue) unless the entity receives something in return for that consideration that is distinct. If consideration payable to a customer is variable, it should be accounted for consistent with the variable consideration guidance in ASC 606 (see Section 7.3).

For purposes of determining whether the good or service received by the entity is distinct, the entity follows the guidance in Section 6.2 (which is used to determine whether a promised good or service is distinct and should be accounted for separately as a performance obligation). If the entity receives a good or service that is distinct, it must determine if its fair value can be reasonably estimated. If the entity cannot reasonably estimate the fair value of the distinct good or service it receives from the customer, the payment made to the customer is treated as a reduction of the transaction price. Otherwise, the cost of the good or service received by the entity is the lesser of the fair value of the good or service provided to the entity and the amount payable to the customer by the entity. This cost is accounted for in the same manner as if the entity had bought the good or service from a party other than its customer. Any excess of the amount payable to the customer over the fair value of the good or service the entity receives from its customer is treated as a reduction of the transaction price.

When some or all of the consideration payable to a customer should be treated as a reduction in the transaction price, that reduction should be reflected upon the later of: (a) when the revenue for the related goods or services transferred to the customer is recognized and (b) when the consideration is paid or promised to the customer (which includes payments made only upon the occurrence of a future event).

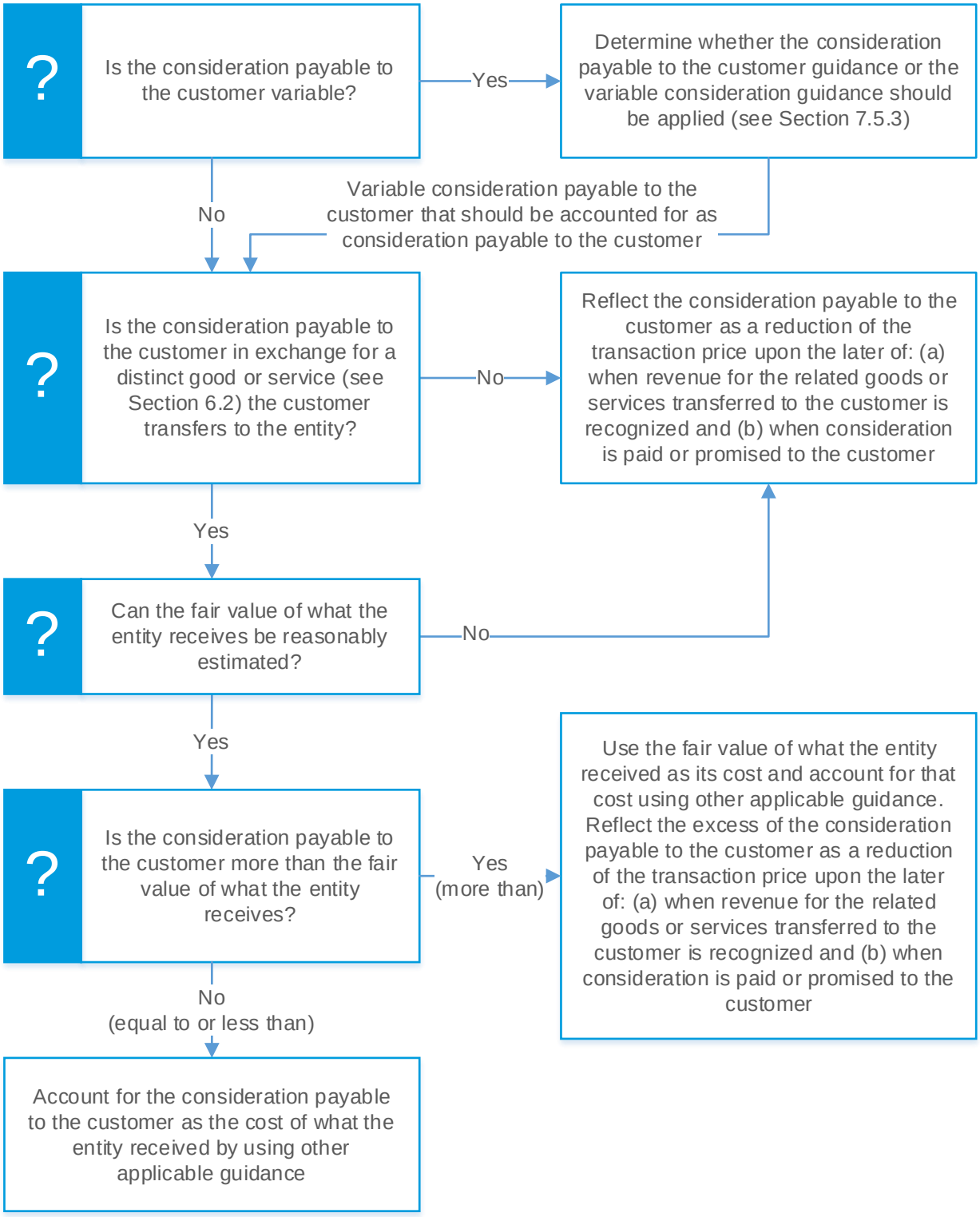


Spotlight on change

Under legacy GAAP, there was a presumption that cash paid by the entity to its customer should be reflected as a reduction of revenue. The presumption was only overcome if the entity received an identifiable and separable benefit and if the entity could reasonably estimate the fair value of the benefit received. There is no presumption about how to treat cash paid to customers under ASC 606. Instead, ASC 606 indicates that such payments should be treated as a revenue reduction unless the entity receives a distinct good or service whose fair value can be reasonably estimated. While there are some similarities between the guidance in ASC 606 and legacy GAAP with respect to the accounting for cash paid to customers, the changes made by ASC 606 (e.g., removal of the presumption, using the concept of distinct) could result in a change in how an entity accounts for cash paid to a customer.

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The accounting for consideration payable to the customer is summarized in the following flowchart.



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7Q.5.2.1 How should consideration payable to a customer in the form of share-based payments be measured and classified?

ASU 2018-07 requires share-based payments awarded to a customer in conjunction with selling goods or services to be accounted for under ASC 606. While ASC 606 provides guidance on presentation, it does not provide guidance on measuring share-based payments to a customer or how to classify such awards on the balance sheet.

To provide guidance regarding the measurement and balance sheet classification of share-based payments to a customer, the FASB issued ASU 2019-08. This ASU requires the application of ASC 718 to measure and classify share-based payments to a customer. The amount to be recorded as a reduction in revenue is based on the grant-date fair value of the share-based payment award. The classification and subsequent measurement of the award are subject to the guidance in ASC 718 unless the share-based payment award is subsequently modified and the grantee is no longer a customer.

7Q.5.2.2 How should consideration payable to a customer in the form of slotting fees be accounted for?

Slotting fees (or allowances) are payments an entity may make to its distributors or retailers to carry its product, and in some cases, to provide specific product placement within a retail location (e.g., a specific shelf or endcap within a grocery store). Because it is not uncommon for slotting fees to be implicit at contract inception and only explicitly granted to a customer (or a customer's customer) after contract inception, entities should ensure they have appropriate processes in place to identify implicit slotting fees the entity intends to offer the customer (or a customer's customer), as well as those price concessions the customer has a valid expectation of receiving based on the entity's customary business practices, published policies or specific statements.

Given that consideration payable to a customer that is variable is accounted for as variable consideration (and not consideration payable to a customer, as discussed in Section 7.5.3), a variable slotting fee should be accounted for as variable consideration. Nonvariable slotting fees should be accounted for as consideration payable to the customer. Consider the following example of how to account for a nonvariable slotting fee.



Example 7-27: Accounting for a slotting fee paid to a customer (ASC 606-10-55-252 to 55-254)

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.

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.

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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RSM COMMENTARY: There is no presumption about how to treat cash paid to customers under ASC 606. Instead, ASC 606 indicates that such payments should be treated as a revenue reduction unless the entity receives a distinct good or service whose fair value can be reasonably estimated.

7Q.5.2.3 How should consideration payable to a customer in the form of cooperative advertising be accounted for?

Cooperative advertising typically refers to situations in which a manufacturer and retailer (or perhaps even others in the distribution chain, such as a distributor) jointly advertise a product. The terms of a cooperative advertising arrangement will vary depending on the parties and products involved and the nature of the cooperative advertising that will be undertaken. In the context of consideration payable to a customer, cooperative advertising typically arises when a retailer requires payment from the manufacturer to advertise the manufacturer's product in a retailer-specific advertisement. In this situation, the retailer is either the manufacturer's customer or a customer of the manufacturer's customer (e.g., the retailer is a customer of a distributor that is a customer of the manufacturer).

Applying the consideration payable to a customer guidance in ASC 606 to cooperative advertising requires an entity to consider whether it receives advertising that is distinct, and if so, then consider the fair value of the advertising in determining the proper accounting. Consider the following example.

Example 7-28: Accounting for cooperative advertising

Company A, a manufacturer of breakfast cereal, enters into a contract to sell Customer B, a grocery retailer, 100,000 boxes of its breakfast cereals at $2 per box. The inventory cost of the cereal is $1.25 per box. In addition, Company A agrees to pay Customer B $25,000 for cooperative advertising in a future edition of Customer B's weekly circular in the Sunday newspaper, which features certain products and special offers at Customer B's retail locations in the coming week. Company A concludes that the cooperative advertising provides it with a distinct service.

Consider the following three cases:

1. The fair value of the cooperative advertising is $15,000, which is less than Company A's payment to Customer B.
2. The fair value of the cooperative advertising is $30,000, which is more than Company A's payment to Customer B.
3. The fair value of the cooperative advertising is not reasonably estimable.

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Company A would record the following journal entry for each case upon transferring control of the breakfast cereal to Customer B:

	Case 1		Case 2		Case 3	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Accounts receivable (Notes 1, 2)	$200,000		$200,000		$200,000	
Cost of goods sold (Note 3)	125,000		125,000		125,000	
Prepaid advertising (Note 4)	15,000		25,000			
Revenue (Note 5)		$190,000		$200,000		$175,000
Inventory (Note 3)		125,000		125,000		125,000
Accounts payable (Note 2)		25,000		25,000		25,000

Note 1: In all three scenarios, 100,000 boxes of breakfast cereal × $2 per box

Note 2: Depending on the facts and circumstances, the accounts receivable from Customer B and the accounts payable to Customer B may have to be presented net.

Note 3: In all three scenarios, 100,000 boxes of breakfast cereal × $1.25 per box.

Note 4: In Cases 1 and 2, Company A recognizes prepaid advertising for the lesser of the fair value of the cooperative advertising and the amount Company A pays Customer B. In Case 3, Company A does not recognize prepaid advertising because the fair value of the cooperative advertising is not reasonably estimable. Company A will recognize advertising expense when its ad runs in Customer B's Sunday circular in the future.

Note 5: In Case 1, (100,000 boxes of breakfast cereal × $2 per box) – ($25,000 payment to Customer B – $15,000 fair value of cooperative advertising). In Case 2, 100,000 boxes of breakfast cereal × $2 per box. In Case 3, (100,000 boxes of breakfast cereal × $2 per box) – $25,000 payment to Customer B



RSM COMMENTARY: Refer to the RSM commentary provided for Example 7-27 for additional information about the changes to legacy GAAP as it relates to consideration payable to a customer.

7.5.3 Interaction of the variable consideration and consideration payable to a customer guidance

If consideration payable to a customer is variable, the question arises as to whether the variable consideration or the consideration payable to the customer guidance in ASC 606 should be used to determine when the consideration payable to the customer should be recognized as a reduction to the transaction price (or otherwise if the entity receives a distinct good or service in return). The question arises because the variable consideration guidance requires an entity to include an estimate of the variable consideration subject to a constraint in the transaction price (which is then recognized when or as the performance obligation(s) is (are) satisfied), while the consideration payable to the customer guidance requires an entity to recognize the consideration payable to the customer at the later of two points in time (only one of which is when the related performance obligation[s] is [are] satisfied).

The FASB staff and TRG discussed whether the variable consideration or the consideration payable to the customer guidance in ASC 606 should be used to determine when consideration payable to the customer should be recognized. This issue was addressed in Question 29 of the FASB RRI Q&As, and the FASB staff and TRG concluded that if the entity is required to make a payment to its customer and

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that payment is variable, the variable consideration guidance should be applied. In addition, the entity should consider whether it intends to make a variable payment to its customer or whether the customer expects to receive a variable payment from the entity because of the entity's customary business practices. In either case, the variable consideration guidance should be applied.

Determining whether the variable consideration or consideration payable to a customer guidance should be applied to variable consideration payable to a customer will require significant judgment to be exercised and careful consideration of all the facts and circumstances. Consider the following example.



Example 7-29: Accounting for variable consideration payable to a customer (Question 29 of the FASB RRI Q&As)

An entity that manufactures consumer goods enters into a contract to sell a new product to a customer (a retail store chain) on December 15th. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer CU1-off coupons in newspapers to encourage consumers to buy the new product. The entity will reimburse the retail store chain for any coupons that are redeemed. The entity has not historically entered into similar coupon offerings in the past. The entity delivers the new consumer goods (1,000 units at CU10/unit) to the retail store chain on December 28th. Assume for this example, that the customer has no right to return the products. On December 31st, the entity decides to make the coupon offering. On January 2nd, the entity communicates to its customer that it will reimburse the retail store chain on March 30th for any coupons redeemed by the retail store's customers. Assume the entity prepares its financial statements based on a calendar year end.



RSM COMMENTARY: Based on the FASB staff's and TRG conclusions, the coupon is not variable consideration because on December 15: (a) the entity is not contractually required to make a payment to its customer and (b) the customer has no basis to expect a payment from the entity given that the entity has not entered into similar coupon offerings in the past. Applying the consideration payable to a customer guidance to this example results in the entity reducing revenue on January 2 (the date the consideration is paid or promised) for the payment it expects to make to the customer for the coupons it expects to be redeemed because that is later than December 28 (when the revenue for the related goods or services was recognized).

Consider the following two alternative fact patterns: (a) the entity communicates to its customer during contract negotiations that it will be making a coupon offering upon introduction of the new product in the market and (b) the customer's customers expect the entity to make a coupon offering upon introduction of the new product in the market because it is the entity's customary business practice to do so. In either case, the consideration payable to the customer in connection with the coupon offering should be considered variable consideration at contract inception. As a result, the entity reduces the transaction price for the payment it expects to make to the customer for the coupons it expects to be redeemed (subject to the variable consideration constraint). The transaction price is then recognized on December 28 when the entity's performance obligation related to the new consumer goods is satisfied.

The difference in the timing of when the revenue reduction is recognized under the variable consideration guidance compared to the consideration payable to a customer guidance (the revenue reduction is recognized sooner under the variable consideration guidance in this example) underscores the importance of carefully analyzing all the facts and circumstances when determining the accounting model that should be applied to variable consideration payable to a customer.

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8. Step 4: Allocate the transaction price to the performance obligations

8.1 General requirements

The overall objective of the guidance on allocating the transaction price is to allocate an amount to each performance obligation (or distinct good or service in a single performance obligation resulting from the series exception [see Section 6.3]) that represents the consideration to which the entity expects to be entitled as a result of transferring control of the underlying goods or services to the customer.

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown to be related to one or more (but less than all) performance obligations. In addition, a contract with one performance obligation also may be affected by the guidance on allocating variable consideration when that one performance obligation is made up of a series of distinct goods or services that are treated as a single performance obligation under the series exception (see Section 6.3).



Spotlight on change

While there are some similarities between the guidance in ASC 606 related to allocating the transaction price to performance obligations and the guidance in the multiple-element arrangement models in legacy GAAP related to allocating the arrangement consideration, there also are many differences that could result in a different amount being allocated to a unit of account for revenue recognition purposes.

For example, while legacy GAAP's general multiple-element arrangement model required allocation of arrangement consideration using a relative selling price model, it did not provide exceptions related to allocating discounts or variable consideration.

For another example, under the general multiple-element arrangement model in legacy GAAP, any arrangement consideration allocated to a delivered element (e.g., equipment) that is contingent on delivery of the undelivered elements (e.g., installation services) in the arrangement was required to be deferred until delivery of those undelivered elements occurs (e.g., the installation services are provided). Under ASC 606, when some or all of the transaction price is contingent upon the delivery of undelivered promised goods or services, the effects of that contingency are addressed by applying the variable consideration guidance. While ASC 606 includes a variable consideration constraint, that constraint is not expected to limit the transaction price to the amount that is not contingent upon delivery of the undelivered promised goods or services in many cases because resolution of the contingency is typically within the entity's control (i.e., the entity typically controls whether it delivers the undelivered promised goods or services). As a result, the change in how amounts contingent upon the delivery of undelivered promised goods or services are treated from an accounting perspective results in recognizing those contingent amounts as revenue sooner under ASC 606 in many cases.

8.2 Standalone selling prices

The standalone selling price of a performance obligation is the amount the entity charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

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The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the entity for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the entity is required to estimate a standalone selling price. In making this estimate, the entity should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the entity, the market, the customer and the customer class. In addition, an entity should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- *Adjusted market assessment approach*. This approach identifies the price at which customers would be willing to buy the underlying goods or services on a standalone basis, which might include looking at prices charged by competitors for similar goods or services and making the appropriate entity-specific adjustments. For entities that operate in highly competitive markets with relatively homogenous goods, competitors' pricing may be helpful in developing an estimate of standalone selling price. The approach generally will not be appropriate for a new product or service.
- *Expected cost plus a margin approach*. This approach builds up a standalone selling price for the underlying goods or services using the costs the entity expects to incur to provide the goods or services and adding an appropriate margin to those costs. For example, this approach may be appropriate in a manufacturing environment when direct and indirect costs are identifiable and can be allocated to a particular product and a standard margin is used in the entity's pricing process. It is unlikely to be appropriate in an industry such as software, where significant upfront research and development costs are incurred, but the incremental cost of transferring each software license is minimal.
- *Residual approach*. This approach may only be used when there is an observable standalone selling price for the other performance obligation(s) in the contract and one of the following criteria is met: (a) the prices at which the entity has sold the goods or services on a standalone basis at or near the same time represent a broad range of prices within which a representative standalone selling price cannot be identified (i.e., the selling price is highly variable) or (b) the goods or services underlying a performance obligation have not previously been sold on a standalone basis and the entity has not yet established a price for those goods or services (i.e., the selling price is uncertain). The standalone selling price of the goods or services to which the residual approach is applied is calculated by determining the difference (i.e., residual) between: (a) the total transaction price and (b) the total observable standalone selling prices for the other goods or services in the contract. As discussed in Section 8.3.1, there are situations in which a discount is allocated to less than all the performance obligations in a contract. If that situation arises when the residual approach will be used to estimate the standalone selling price of a performance obligation, the entity should allocate the discount before using the residual approach to estimate the standalone selling price.

These approaches to estimating the standalone selling price of a performance obligation may only be used when the performance obligation does not have an observable standalone selling price. Upon estimating a standalone selling price using any of these methods, the entity should ensure that the outcome is consistent with the objective of identifying the amount the entity would charge if it sold the underlying good or service on its own (or the underlying group of goods or services on its own). For example, as illustrated in Case C of Example 8-4, an entity ultimately should determine that using the residual approach to estimate the standalone selling price of a good or service does not meet that objective because the standalone selling price determined using the residual approach falls outside the broad price range within which the entity has sold the good or service.

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Other approaches to estimating the standalone selling price of a performance obligation in the absence of an observable standalone selling price may be appropriate if the objective of those approaches is to identify the amount the entity would charge if it sold the underlying good or service on its own (or the underlying group of goods or services on its own). In addition, when an observable standalone selling price does not exist, it may be appropriate or necessary to use more than one approach to estimate the standalone selling prices for the goods or services in the contract (e.g., the adjusted market assessment approach for one good or service and the expected cost plus a margin approach for another good or service).



Example 8-1: Estimating a standalone selling price using the residual approach

Company A enters into a contract to sell Customer B five different products (L, M, N, O and P) for $100,000. Company A determines that each product is a performance obligation (see Chapter 6). Company A regularly sells Products L, M, N and O on a standalone basis to similar customers in similar circumstances. The observable standalone selling price of each product is $30,000, $25,000, $20,000 and $15,000, respectively. Product P is a new product very recently introduced to the market that is different from the products historically offered by Company A. As a result, Company A has not yet established a price list for Product P and has not yet sold it on a standalone basis. For all these reasons, Company A believes the price of Product P is highly uncertain, and therefore calculates the standalone selling price of Product P as follows using the residual approach, given that it has observable standalone selling prices for the other products in the contract:

Performance obligation	Observable standalone selling prices (SSP)
Product L	$30,000
Product M	25,000
Product N	20,000
Product O	15,000
Total	$90,000

	Calculation of SSP for Product P
Transaction price	$100,000
Total of SSPs for other products	(90,000)
SSP for Product P	$10,000

Company A believes a $10,000 standalone selling price for Product P meets the allocation objective because it will result in Company A earning a profit margin that is within the range of profit margins it earns on the other products it sells.



Spotlight on change

Under the general multiple-element arrangement model in legacy GAAP, a three-level hierarchy was used to identify selling prices compared to what is essentially a two-level hierarchy in ASC 606. As a result, the manner in which an entity identifies the selling prices to be used for purposes of allocating the transaction price to performance obligations, and the standalone selling prices themselves, could change. In turn, this would affect the amount of revenue allocated to each unit of account. In addition, while ASC 606 permits the use of a residual method to estimate the standalone selling price of a performance obligation under

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certain circumstances, the general multiple-element arrangement model in legacy GAAP did not permit the use of residual methods.

The legacy GAAP for software transactions required use of VSOE of fair value for purposes of allocating arrangement consideration in a multiple-element arrangement. If VSOE of fair value did not exist for an undelivered element, the elements in an arrangement were not treated separately for accounting purposes. ASC 606 does not require VSOE of fair value for allocation purposes and requires estimation of standalone selling prices for all performance obligations in the absence of an observable price charged for performance obligations when they are sold separately in similar circumstances to similar customers. In addition, legacy GAAP for software transactions required use of a residual method when VSOE of fair value only exists for the undelivered elements. However, this circumstance and the way in which the residual method was applied differed from the circumstances and the way in which a residual method may be used under ASC 606. For example, applying the residual method under legacy GAAP for software transactions could have resulted in allocating no revenue to the delivered element(s). While this would have been acceptable under legacy GAAP for software transactions, it would not be acceptable under ASC 606 because allocating no revenue to a performance obligation would not be consistent with the allocation objective. In other words, it is counterintuitive to think that an entity would expect to be entitled to no revenue as a result of transferring control of the underlying good or service to a customer.

8Q.2.1 Does the contract price or list price for a good or service represent the good's or service's standalone selling price?

Whether the contract price or list price for a good or service represents the good's or service's standalone selling price depends on the facts and circumstances. There is no presumption that the contract price or list price for a good or service represents its standalone selling price, nor is there a presumption that the contract price or list price for the good or service does not represent its standalone selling price.

If the contract price or list price for a good or service is different from the observable price charged by the entity for that good or service when it is sold separately in similar circumstances to similar customers, the contract price or list price does not represent the good's or service's standalone selling price because the observable price (to the extent one exists) should be used as the standalone selling price.

When an observable standalone selling price does not exist, the contract price or list price for a good or service is one data point that should be considered by the entity in addition to other data points (such as the standalone selling price for the good or service estimated using the adjusted market assessment approach or the expected cost plus a margin approach). Only after considering all reasonably available and relevant data points will an entity know if the contract price or list price for a good or service represents the good's or service's standalone selling price. Question 8Q.2.3 discusses other data points that may be considered by an entity when an observable standalone selling price does not exist.

8Q.2.2 Is it possible for the products or services underlying a performance obligation to have more than one standalone selling price?

Yes. The standalone selling price for the products or services underlying a performance obligation may vary as a result of many factors, including the customer class and the geographic region in which the entity sells its products and services. When an entity believes it is appropriate for the products or services underlying a performance obligation to have more than one standalone selling price, it should document the basis and support for that conclusion.

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8Q.2.3 What are the data points an entity should consider in estimating the standalone selling price for a good or service when an observable standalone selling price does not exist?

As discussed in Question 8Q.2.1, the contract price or list price is one data point that should be considered in estimating the standalone selling price for a good or service when an observable standalone selling price does not exist. Paragraph BC269 of ASU 2014-09 lists the following as information that may be considered:

a. Reasonably available data points (for example, a standalone selling price of the good or service, the costs incurred to manufacture or provide the good or service, related profit margins, published price listings, third-party or industry pricing, and the pricing of other goods or services in the same contract)

b. Market conditions (for example, supply and demand for the good or service in the market, competition, restrictions, and trends)

c. Entity-specific factors (for example, business pricing strategy and practices)

d. Information about the customer or class of customer (for example, type of customer, geographical region, and distribution channel).

The type of information used to estimate standalone selling price will vary significantly across industries and entities and even within an entity based on the products or services offered. Paragraph 9.4.31 of the Revenue Recognition AAG provides examples of the types of information that may be considered in developing an estimate. The following list is not all inclusive but includes data that may be helpful to consider as entities develop estimates of standalone selling price.

- *Historical selling prices.* Even if limited standalone sales exist, historical pricing may still be relevant in determining an estimate for current standalone selling price. For example, standalone renewal sales of software maintenance may be an appropriate data point to use when estimating the standalone selling price of maintenance in an initial combined contract including both software and maintenance services.
- *Competitor pricing for similar products*. For entities that operate in highly competitive markets with relatively homogenous goods, competitors' pricing may be helpful in developing an estimate of standalone selling price.
- *Entity's pricing for similar products.* Entities that have observable standalone selling prices for similar products may be able to use that pricing as a starting point, adjusting for differences in functionality and features.
- *Industry or entity pricing practices*. Entities will typically have certain pricing or profit objectives and methods of developing pricing for products for similar products. For example, when prices are developed based on costs incurred plus a target profit margin, a cost-plus-margin approach may be used to estimate a standalone selling price.
- *Effect of proposed transaction on pricing and the class of the customer*. Entities should consider the size of the deal, the characteristics of the targeted customer, the geography of the customer, or the attractiveness of the market in which the customer resides when developing an estimate of standalone selling price.
- *Published price lists*. While price lists cannot be assumed to be equivalent to standalone selling price, they may be a useful data point to estimate a standalone selling price.
- *Valuation techniques*. In some cases, the use of a valuation technique, such as estimating the value of IP using expected future cash flows based on a reasonable royalty rate, may be appropriate.

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The data points accumulated by an entity should be considered in conjunction with one another. In other words, an entity should not just pick a single data point and determine their best estimate of selling price based on that alone.

8Q.2.4 Can standalone selling price be estimated as a range of prices?

Yes, a range may be an appropriate estimate of the standalone selling price; however, the range should be sufficiently narrow so that any price within the range represents a price that the entity would accept if the product or service were sold regularly on a standalone basis. If a range of prices is utilized, that range should not be developed in a manner inconsistent with what an entity would sell the product or service for regularly on a standalone basis. For example, we believe that starting with a single price at which a product or service is sold (or multiple prices within a narrow range) and adding an arbitrary percentage to both sides of that price to estimate the range would be inappropriate.

As noted in paragraph 9.4.41 of the Revenue Recognition AAG, when using a range to estimate standalone selling price, entities also must select a reasonable and systematic approach when allocating the transaction price when the stated contractual price for a distinct good or service is outside of that range, For example, the use of a consistent point in the range, such as the midpoint of the range, may be appropriate, as long as the overall allocation objective in ASC 606-10-32-28 is still met.

8.3 Allocating the transaction price on a relative standalone selling price basis

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Consider the following example.



Example 8-2: Allocating the transaction price on the relative standalone selling price basis (no discounts or variable consideration)

Company A enters into a contract to sell Customer B three different pieces of equipment (X, Y and Z) for a total of $2.5 million. Company A determines that each piece of equipment is a performance obligation (see Chapter 6). Company A regularly sells each piece of equipment on a standalone basis to similar customers in similar circumstances. The standalone selling price of each piece of equipment and the allocation of the $2.5 million transaction price to each performance obligation on a relative standalone selling price basis is illustrated in the table that follows:

Performance obligation (PO)	Standalone selling price (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($2,500,000) to each PO
Equipment X	$500,000	20%	$500,000
Equipment Y	750,000	30%	750,000
Equipment Z	1,250,000	50%	1,250,000
Total	$2,500,000	100%	$2,500,000

The portion of the $2.5 million transaction price allocated to each performance obligation is the same as the standalone selling price for each performance obligation because there are no discounts or variable consideration.

While this scenario is uncommon in practice, it is illustrated here to present the most basic of fact patterns, which is then modified throughout the remainder of this chapter to illustrate different aspects of the guidance on allocating the transaction price. For example: (a) Example 8-3 changes the facts in this

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example to add a discount and (b) Example 8-5 changes the facts in this example to add variable consideration.

8.3.1 Allocating discounts

If the sum of the standalone selling prices for the performance obligations in a contract is more than the transaction price for the contract, the entity has provided the customer with a discount. For example, if an entity is selling three pieces of equipment that are each a performance obligation for a total of $1 million, but the sum of the standalone selling prices for those three pieces of equipment is $1.2 million, the contract includes a discount. A discount should be allocated on a proportionate basis to each of the performance obligations, which happens automatically when allocating the (discounted) transaction price on the relative standalone selling price basis, unless there is observable evidence indicating that the whole discount should be allocated to less than all the performance obligations. The following criteria must be met to conclude that observable evidence exists in support of the whole discount being allocated to one or more (but less than all) performance obligations:

- Each distinct good or service (or each bundle of distinct goods or services) in the contract is regularly sold by the entity on a standalone basis.
- A bundle (or bundles) of some of the distinct goods or services in the contract are regularly sold by the entity on a standalone basis at a discount to the sum of their standalone selling prices.
- The discount at which the entity sells each bundle of distinct goods or services is substantially the same as the discount the entity provided on the contract as a whole, and an analysis of the distinct goods or services in each bundle sold at a discount provides observable evidence of the performance obligation(s) to which the whole contract discount should be allocated.

Implicit in these criteria is that the distinct goods or services in the contract that are not part of the bundle of distinct goods or services regularly sold at a discount are not themselves regularly sold at discount. For these criteria to be met, there typically must be at least three performance obligations: (a) a bundle of at least two performance obligations that is regularly sold by the entity at a discount that matches the entire discount in the contract and (b) one performance obligation to which it can be shown that none of the discount relates.

If all of the criteria are met, the entity allocates the whole discount in the contract to the performance obligation (or bundle of performance obligations) sold at a discount. If less than all of these criteria are met, the entity allocates the discount on a proportionate basis to all performance obligations in the contract on a relative standalone selling price basis. Continuing with the example introduced earlier, if the facts and circumstances indicate that the $200,000 discount relates to only two of the three pieces of equipment being sold to the customer because the criteria discussed earlier are met, then the discount is allocated to just those two pieces of equipment using their standalone selling prices. Conversely, if the facts and circumstances indicate that the $200,000 discount relates to all three pieces of equipment being sold to the customer because the criteria discussed earlier are not met, then the discount is allocated to all three pieces of equipment. The following examples provide detailed numerical illustrations showing how to allocate the transaction price when the contract includes a discount.



Example 8-3: Allocating a transaction price when there is a discount

Company A enters a contract to sell Customer B three different pieces of equipment (X, Y and Z) for a total of $2 million. Company A determines that each piece of equipment is a performance obligation (see Chapter 6). Company A regularly sells each piece of equipment on a standalone basis to similar

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customers in similar circumstances. The standalone selling prices for the three pieces of equipment is $2.5 million and as a result, there is a $500,000 discount inherent in the contract.

Case 1

Company A does not have evidence that the discount relates to just one or two of the performance obligations. As a result, Company A allocates the $2 million transaction price to each performance obligation on a relative standalone selling price basis as follows:

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($2,000,000) to each PO
Equipment X	$500,000	20%	$400,000
Equipment Y	750,000	30%	600,000
Equipment Z	1,250,000	50%	1,000,000
Total	$2,500,000	100%	$2,000,000

The discount was allocated evenly across all three performance obligations because Company A did not have evidence that the discount related to just one or two of the performance obligations.

Case 2

Company A regularly sells Equipment Y and Z together for $1.5 million. Company A concludes that the $500,000 discount in the contract as a whole should be allocated to Equipment Y and Z because:

- Each piece of equipment in the contract is regularly sold by Company A on a standalone basis.
- Equipment Y and Z are regularly sold by Company A for $1.5 million, which is a $500,000 discount from the sum of their standalone selling prices of $2 million ($750,000 standalone selling price of Equipment Y + $1,250,000 standalone selling price of Equipment Z).
- Equipment X is not regularly sold by Company A at a discount.
- The $500,000 discount at which Company A sells Equipment Y and Z is the same as the $500,000 discount it provided on the contract as a whole, and Company A's analysis of situations in which Equipment Y and Z are sold at a discount provides observable evidence that the $500,000 discount in the contract as a whole should only be allocated to Equipment Y and Z (i.e., none of the discount should be allocated to Equipment X).

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As a result, Company A allocates the $2 million transaction price to each performance obligation as follows:

Performance obligation (PO)	Standalone selling prices (SSP)	Allocation of discount to Equipment Y and Z	Allocation of transaction price ($2,000,000) to each PO
Equipment X	$500,000		$500,000
Equipment Y (Note 1)	750,000	($187,500)	562,500
Equipment Z (Note 2)	1,250,000	(312,500)	937,500
Total		($500,000)	$2,000,000

Note 1: $500,000 discount × ($750,000 standalone selling price of Equipment Y ÷ [$750,000 standalone selling price of Equipment Y + $1,250,000 standalone selling price of Equipment Z])

Note 2: $500,000 discount × ($1,250,000 standalone selling price of Equipment Z ÷ [$750,000 standalone selling price of Equipment Y + $1,250,000 standalone selling price of Equipment Z])

If Company A regularly sold Equipment X at a discount, it likely would allocate the discount in this example proportionately across all three performance obligations.



Example 8-4: Allocating the transaction price when there is a discount and when the residual value approach is used to estimate a standalone selling price (ASC 606-10-55-259 to 55-269)

An entity regularly sells Products A, B, and C individually, thereby establishing the following standalone selling prices:

Product	Standalone Selling Price
Product A	$40
Product B	55
Product C	45
Total	$140

In addition, the entity regularly sells Products B and C together for $60.

Case A—Allocating a Discount to One or More Performance Obligations

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.

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.

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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.

If the contract requires the entity to transfer control of Products B and C at different points in time, then the allocated amount of $60 is individually allocated to the promises to transfer Product B (standalone selling price of $55) and Product C (standalone selling price of $45) as follows:

Product	Allocated Transaction Price	
Product B	$33	($55 ÷ $100 total standalone selling price × $60)
Product C	27	($45 ÷ $100 total standalone selling price × $60)
Total	$60	

Case B—Residual Approach Is Appropriate

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.

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.

As in Case A, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has observable evidence that $100 should be allocated to those 3 products and a $40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37. Using the residual approach, the entity estimates the standalone selling price of Product D to be $30 as follows:

Product	Standalone Selling Price	Method
Product A	$40	Directly observable (see paragraph 606-10-32-32)
Products B and C	60	Directly observable with discount (see paragraph 606-10-32-37)
Product D	30	Residual approach (see paragraph 606-10-32-34(c))
Total	$130	

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

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

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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.

8.3.2 Allocating variable consideration

Variable consideration included in the transaction price (see Section 7.3) should be allocated on a proportionate basis to each of the performance obligations in a contract, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the entity's efforts to: (a) satisfy, or achieve a specific outcome from satisfying, a specific performance obligation or (b) transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception (see Section 6.3).
- Allocating the variable payment to the specific performance obligation or distinct good or service in a single performance obligation resulting from the series exception depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract.

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in their entirety to the specific performance obligation or distinct good or service to which the variable payment relates.

The remaining transaction price in the arrangement is allocated as it otherwise would be under ASC 606 (i.e., allocated on a relative standalone selling price basis unless the discount exception applies).



Example 8-5: Allocating the transaction price when there is variable consideration in the form of a bonus

Company A enters a contract to sell Customer B three different pieces of equipment (X, Y and Z) for a total of $2 million plus a potential bonus. Company A determines that each piece of equipment is a performance obligation (see Chapter 6). Company A regularly sells each piece of equipment on a standalone basis to similar customers in similar circumstances. The standalone selling prices for the three pieces of equipment is $2.5 million. Company A does not have evidence that the discount relates to just one or two of the performance obligations.

Case 1

Company A will receive a bonus of $50,000 if it delivers all three pieces of equipment by December 15, 20X1. Otherwise, the delivery date for all three pieces of equipment is no later than January 15, 20X2. Company A believes (and can support that) it will deliver all three pieces of equipment by December 15, 20X1 and that it is probable that including the $50,000 bonus in the transaction price will not result in a significant reversal of cumulative revenue recognized upon determining the final delivery date of the equipment. As a result, the transaction price is $2,050,000.

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Because the bonus relates to delivering all three pieces of equipment on time, Company A allocates the $50,000 proportionately to all three pieces of equipment. Company A allocates the $2,050,000 transaction price to each performance obligation as follows:

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($2,050,000) to each PO
Equipment X	$500,000	20%	$410,000
Equipment Y	750,000	30%	615,000
Equipment Z	1,250,000	50%	1,025,000
Total	$2,500,000	100%	$2,050,000

Example 8-9 illustrates how to account for a change in the transaction price in this example after contract inception.

Case 2

Company A will receive a bonus of $50,000 if it delivers Equipment Y by December 15, 20X1. Otherwise, the delivery date for all three pieces of equipment is no later than January 15, 20X2. Company A believes (and can support that) it will deliver Equipment Y by December 15, 20X1 and that it is probable that including the $50,000 bonus in the transaction price will not result in a significant reversal of cumulative revenue recognized upon determining the final delivery date for Equipment Y.

The $50,000 bonus meets the criteria to be allocated in its entirety to the Equipment Y performance obligation because:

- The terms under which the $50,000 bonus is paid are specifically related to Company A's satisfaction of the Equipment Y performance obligation by December 15, 20X1.
- Allocating the $50,000 bonus to the Equipment Y performance obligation depicts the amount of consideration to which Company A expects to be entitled in exchange for transferring Equipment Y to Customer B early (compared to Equipment X and Z) because of the disruption doing so will cause to Company A's production schedule and the overtime its employees will incur.

As a result, Company A allocates the $2,050,000 transaction price to each performance obligation as follows:

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of nonvariable transaction price (TP) ($2,000,000) to each PO	Allocation of variable TP ($50,000)	Allocation of total TP ($2,050,000)
Equipment X	$500,000	20%	$400,000		$400,000
Equipment Y	750,000	30%	600,000	$50,000	650,000
Equipment Z	1,250,000	50%	1,000,000		1,000,000
Total	$2,500,000	100%	$2,000,000	$50,000	$2,050,000

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Example 8-6: Allocating the transaction price when there are two licenses of IP and variable consideration in the form of a sales-based royalty (ASC 606-10-55-270 to 55-279)

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

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.

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.

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.

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

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.

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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.



RSM COMMENTARY: The following journal entries relate to Case B.

Assuming the $300 fixed payment is a nonrefundable upfront payment, upon transfer of License Y, the entity records the following journal entry:

	Debit	Credit
Cash	$300	
Revenue		$167
Contract liability		133

For the royalties due in the first month, the entity records the following journal entry:

	Debit	Credit
Accounts receivable	$200	
Revenue		$111
Contract liability		89

Assuming the royalties in the second and third months also are $200 for each month, the entity records the following journal entry:

	Debit	Credit
Accounts receivable	$400	
Revenue		$222
Contract liability		178

Upon transfer of License X on the first day of the fourth month, the entity recognizes the following journal entry:

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	Debit	Credit
Contract liability (Note 1)	$400	
Revenue (Note 1)		$400

Note 1: The amount allocated to License X and recorded as a contract liability prior to its transfer to the customer is $400 ($133 + $89 + $178). This amount also can be calculated by applying the relative standalone selling price percentage for License X to the total consideration received or payable to the entity prior to the transfer of License X ([$300 + $200 + $400] × [$800 ÷ $1,800] = $400).

On a going-forward basis, because both performance obligations have been satisfied upon the transfer of License X, the entity recognizes revenue for the royalties as the customer makes future sales of products that use License Y.



Example 8-7: Allocating the transaction price between a franchise license and equipment when there is variable consideration in the form of a sales-based royalty (ASC 606-10-55-375 to 55-379)

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

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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.



RSM COMMENTARY: Example 10-12 addresses when the allocated transaction price should be recognized as revenue.

8.3.2.1 Allocating variable consideration to a series of distinct goods or services

As discussed in Section 6.3, a series of distinct promised goods or services that are substantially the same *should* be considered a single performance obligation and accounted for as one unit of account if certain criteria are met. This is commonly referred to as the series exception. As discussed in Section 8.3.2, variable consideration should be allocated in its entirety to the distinct good or service within a series to which the variable payment relates when the following two criteria are met:

- The terms of the variable payment are specifically related to the entity's efforts to transfer, or achieve a specific outcome from transferring, the distinct good or service.
- Allocating the variable payment to the distinct good or service depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract.

When variable consideration meets the criteria above, an entity is not required to estimate that variable consideration since the amount would become known at the same time the distinct good or service is transferred to the customer and revenue is recognized. For example, for a quarterly asset management fee calculated based on assets under management at the end of each quarter, if the quarterly asset management fee relates specifically to the entity's efforts to transfer the distinct increments of service for a specific quarter, the entity should allocate the quarterly asset management fee to the distinct increments of service provided during that quarter (see Example 7-9).



Example 8-8: Allocating the transaction price when there is variable consideration and a single performance obligation consisting of distinct goods or services resulting from the series exception (ASC 606-10-55-157B to 55-157E)

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.

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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.

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.

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.



RSM COMMENTARY: Section 6.3 addresses the circumstances under which the series exception applies. In addition, this example illustrates one of the reasons why the FASB provided the series exception, which is discussed in Question 6Q.3.3. If the FASB had not provided this exception, the daily variable consideration would have to be estimated and then allocated to the single performance obligation as a whole and recognized over the contract term for the single performance obligation. Instead, because the exception applies, the daily variable consideration does not need to be estimated and instead is allocated to each distinct day of hotel management services and recognized on that day as control of the services transfers to the customer.

8.3.3 Allocating a significant financing component

There is no specific guidance in ASC 606 related to allocating the effects a significant financing component has on the transaction price (see Section 7.4). As a result, it was not clear whether entities

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could analogize to the guidance on allocating discounts and variable consideration for purposes of allocating the effects of a significant financing component to less than all the performance obligations, or if their only option was to allocate those effects on a proportional basis to all performance obligations in the contract.

The FASB staff and TRG discussed how the effects of a significant financing component on the transaction price should be allocated when the contract includes multiple performance obligations. This issue was addressed in Question 37 of the FASB RRI Q&As, and the FASB staff and TRG concluded that it may be appropriate in some circumstances to analogize to the guidance on allocating discounts and variable consideration for purposes of allocating the effects of a significant financing component to one or more (but less than all) of the performance obligations to which the financing component directly relates. In making such an analogy, the entity should ensure that the end result is consistent with the overall objective of allocating the transaction price (see Section 8.1).

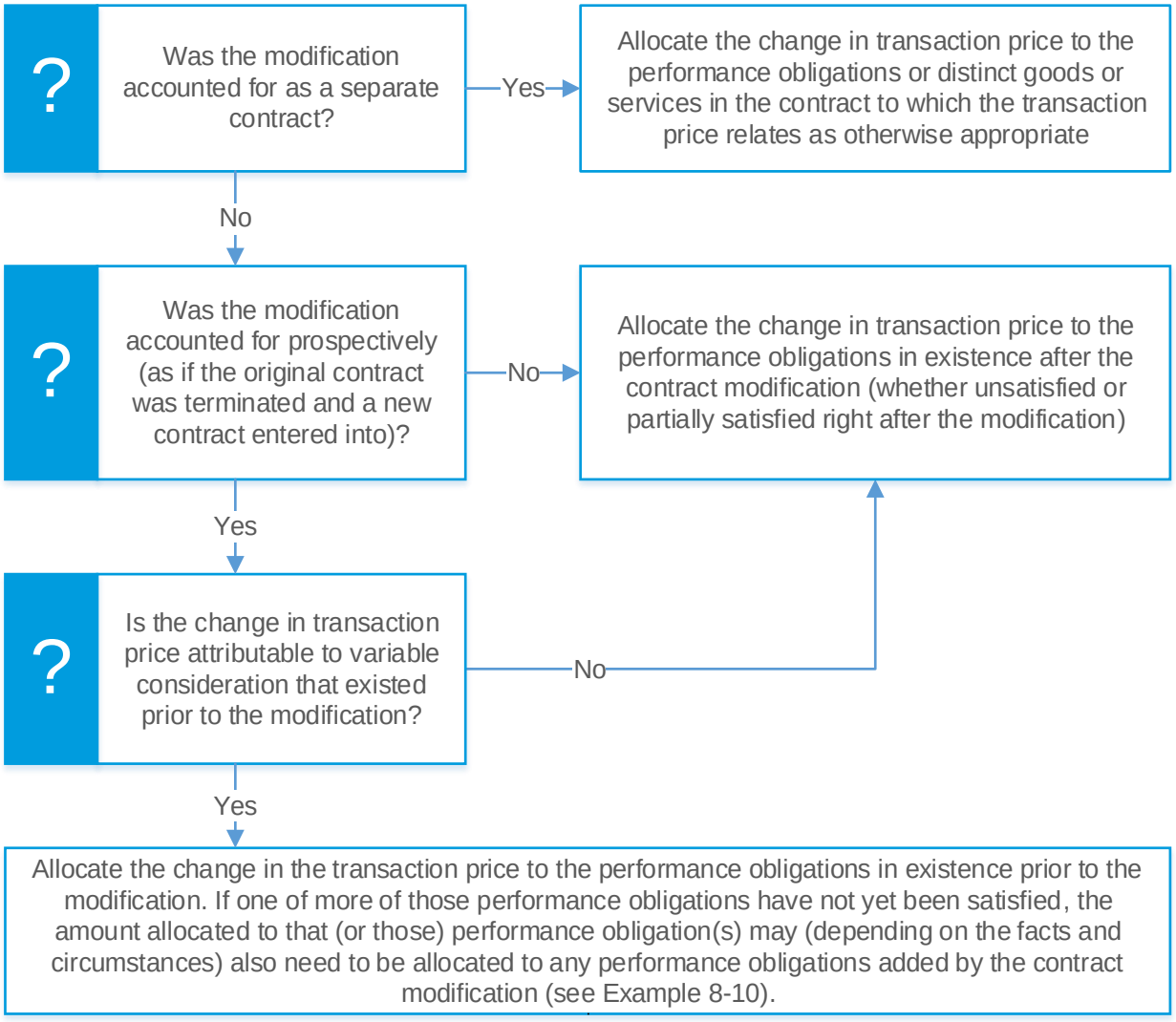
8.4 Changes in the transaction price

Changes in the transaction price that are caused by contract modifications are accounted for in accordance with the contract modification guidance in ASC 606 (see Section 5.5).

Changes in the transaction price, other than those resulting from contract modifications, may be caused by changes in one or more of the numerous factors taken into consideration when estimating the transaction price, such as an entity's expectations about the likelihood of it being entitled to variable consideration. In these situations, any necessary change to the transaction price generally should be allocated to the performance obligations on the same basis and using the same standalone selling prices that were used to allocate the transaction price at contract inception. This includes situations in which variable consideration was allocated to one or more (but less than all) performance obligations or distinct goods or services in a single performance obligation (resulting from application of the series exception) to which the variable consideration directly relates (as discussed in Section 8.3.2 and Section 8.3.2.1).

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As the following flowchart illustrates, accounting for a change in the transaction price after (but not as a result of) a contract modification depends, at least in part, on the accounting model applied to the modification.



If some or all of the change in transaction price is allocated to a performance obligation that already has been satisfied (i.e., for which revenue already has been recognized), the allocated adjustment amount should be reflected as an increase or decrease to revenue, as appropriate, in the period of the adjustment.

Example 8-9: Change in the transaction price due to reassessment of receiving a bonus (and not a modification)

Company A enters a contract to sell Customer B three different pieces of equipment (X, Y and Z) for a total of $2 million plus a potential bonus. Company A determines that each piece of equipment is a performance obligation (see Chapter 6). Company A regularly sells each piece of equipment on a standalone basis to similar customers in similar circumstances. The standalone selling prices for the three pieces of equipment is $2.5 million. Company A does not have evidence that the discount relates to just

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one or two of the performance obligations. Company A will receive a bonus of $50,000 if it delivers all three pieces of equipment by December 15, 20X1. Otherwise, the delivery date for all three pieces of equipment is no later than January 15, 20X2. Company A believes (and can support that) it will deliver all three pieces of equipment by December 15, 20X1 and that it is probable that including the $50,000 bonus in the transaction price will not result in a significant reversal of cumulative revenue recognized upon determining the final delivery date of the equipment. As a result, the transaction price is $2,050,000.

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($2,050,000) to each PO
Equipment X	$500,000	20%	$410,000
Equipment Y	750,000	30%	615,000
Equipment Z	1,250,000	50%	1,025,000
Total	$2,500,000	100%	$2,050,000

Company A transfers control of Equipment Y and Z on September 30, 20X1 and still expects (and can support) shipping Equipment X before December 15, 20X1. Assuming Company A is not entitled to receive payment until control of all three pieces of equipment has transferred to Customer B, Company A records the following journal entry upon transferring control of Equipment Y and Z:

	Debit	Credit
Contract asset (Note 1)	$1,640,000	
Revenue (Note 1)		$1,640,000

Note 1: $615,000 of transaction price allocated to Equipment Y + $1,025,000 of transaction price allocated to Equipment Z

On November 30, 20X1, Company A concludes it will not be able to deliver Equipment X to Customer B by December 15, 20X1 due to unforeseen difficulties in obtaining raw materials from its suppliers. As a result, Company A reduces the transaction price to $2 million. Because the transaction price allocated to Equipment Y and Z already has been recognized as revenue, Company A should record an adjustment to reduce revenue as follows:

Performance obligation (PO)	Standalone selling prices (SSP)	SSP of each PO to total SSPs	Allocation of transaction price ($2,000,000) to each PO	Transaction price already recognized as revenue	Revenue reduction due to change in transaction price
Equipment X	$500,000	20%	$400,000	$ -	$ -
Equipment Y	750,000	30%	600,000	615,000	(15,000)
Equipment Z	1,250,000	50%	1,000,000	1,025,000	(25,000)
Total	$2,500,000	100%	$2,000,000	$1,640,000	($40,000)

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Company A records the following journal entry on November 30, 20X1 to reduce revenue for the change in the transaction price due to it no longer expecting to meet the December 15, 20X1 deadline for delivering Equipment X:

	Debit	Credit
Revenue	$40,000	
Contract asset		$40,000

On January 15, 20X2, Company A transfers control of Equipment X to Customer B and records the following journal entry:

	Debit	Credit
Accounts receivable	$2,000,000	
Revenue		$400,000
Contract asset (Note 1)		1,600,000

Note 1: $1,640,000 recognized on September 30, 20X1 – $40,000 derecognized on November 30, 20X1



Example 8-10: Change in the estimated variable consideration included in the transaction price after a contract modification (ASC 606-10-55-117 to 55-124)

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.

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.

When Product X transfers to the customer at contract inception, the entity recognizes revenue of $600.

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.

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

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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.



RSM COMMENTARY: This example illustrates that a change in variable consideration that existed prior to the contract modification is allocated to the performance obligations in existence prior to the modification even though the modification is accounted for as if the original contract was terminated and a new contract was entered into (see Section 5.5). To the extent one or more of the performance obligations to which the change in transaction price is allocated:

- Have been satisfied, the amount allocated to the one or more satisfied performance obligations is recognized as revenue in the period of the change

Have not been satisfied, the amount allocated to the unsatisfied performance obligation(s) is allocated across those performance obligations and any performance obligations added by the contract modification as it otherwise would be (on a relative standalone selling price basis, taking into consideration the variable consideration exception)

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9. Step 5: Recognize revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it.

To properly assess when revenue should be recognized, an entity must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time. Central to this evaluation is understanding what constitutes *control having transferred to the customer*.

9Q.1 How does an entity recognize revenue for goods or services transferred to a customer before it enters into a contract with the customer that meets the contract existence criteria?

As discussed in more detail in Question 5Q.1.2, when an entity transfers control of goods or services to the customer before it enters into a contract with that customer that meets the contract existence criteria, no revenue is recognized (even for nonrefundable cash already received by the entity) until either: (a) a contract is entered into, all of the contract existence criteria are met and application of the remaining steps in the five-step revenue recognition model results in revenue recognition or (b) the entity's circumstances are the same as one of the three circumstances under which revenue is recognized when the contract existence criteria have not been met (see Section 5.2.2).

9.1 Transfer of control

In discussing the concept of when control of a good or service transfers to a customer, ASC 606 refers to control of an *asset* transferring. The asset referred to is the good(s) or service(s) in the performance obligation being evaluated for revenue recognition. While the term *asset* is not often used to refer to a service, ASC 606-10-25-25 indicates that "[g]oods 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 has transferred to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits, which includes the customer being able to stop others from directing the use of the asset and receiving substantially all of the related remaining benefits. For this purpose, benefits are considered in terms of the potential cash flows the customer can obtain or save (directly or indirectly) as a result of having control of the asset. Examples of the manner in which an asset may be used to generate cash inflows or reduce cash outflows either directly or indirectly include the following:

- Using the asset to manufacture goods or deliver services, enhance another asset's value, pay liabilities or cut expenses
- Selling the asset
- Exchanging the asset
- Pledging the asset as collateral for a loan
- Holding the asset

ASC 606 provides several indicators that should be considered in assessing whether control of an asset has transferred to the customer. When present, the following indicators may signal that the customer has the ability to direct the use of the asset (and restrict others' use of the asset) and receive substantially all of the asset's remaining benefits:

- The customer is presently obligated to pay the entity for the transferred asset

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- The customer has legal title to the transferred asset (see Section 6.1.2 for discussion of FOB shipping terms)
- The customer has physical possession of the transferred asset
- The customer has the significant risks and rewards of owning the asset
- The customer has accepted the asset (see Section 9.10)

For purposes of determining whether the significant risks and rewards of owning the asset have transferred to the customer, the entity should only consider the risks associated with owning the asset included in the performance obligation for which control transfer is being evaluated (e.g., equipment) and not the risks associated with owning the asset(s) included in other performance obligations in the contract for which control transfer will be evaluated separately (e.g., ongoing maintenance services for the equipment).

It is important to note the following about the presence or absence of an indicator:

- *The presence of an indicator is not determinative evidence that control has transferred to the customer*. For example, the customer may have legal title and physical possession of product transferred subject to a call option, but the entity concludes the customer does not have the ability to direct the use of the product and receive substantially all of the product's remaining benefits because of that call option (see Section 9.7.1). As a result, control has not transferred to the customer even though at least two of the indicators are present.
- *The absence of an indicator is not determinative evidence that control has not transferred to the customer*. For example, an entity might retain legal title to product transferred to the customer to protect itself in case of nonpayment. If other indicators are present in this situation that cause the entity to conclude that the customer still has the ability to direct the use of the product and receive substantially all of the product's remaining benefits prior to obtaining legal title, then control has transferred to the customer despite one of the indicators not being present.

Determining whether control of an asset has transferred to a customer often will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

9.2 Determining whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, an entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time. If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the entity's performance at the same time as: (a) the customer receives those benefits and (b) the entity performs and creates those benefits.
- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the entity's performance.
- *No alternative use and an enforceable right to payment for performance to date.* A performance obligation is satisfied over time if: (a) the asset created by the entity's performance does not have an alternative use to the entity upon its completion and (b) the entity's right to payment for its performance to date is enforceable.

If a performance obligation does not meet any of these three criteria, it is considered satisfied at a point in time. The same criteria are evaluated regardless of whether the performance obligation includes one or

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more promised goods or services. In addition, these criteria include no predispositions that will result in a performance obligation that includes a promised good being satisfied at a point in time or a performance obligation that includes a promised service being satisfied over time. Each performance obligation should be evaluated against these criteria to determine whether revenue should be recognized over time or at a point in time. Determining whether a performance obligation meets one of these criteria may require significant judgment to be exercised and careful consideration of all the facts and circumstances.

9Q.2.1 If an entity is recognizing revenue under legacy GAAP at a point in time for goods it manufactures to the customer's specifications, is it safe to assume that it will continue to recognize revenue under ASC 606 at a point in time for those goods?

No. This issue was addressed in Question 54 of the FASB RRI Q&As, and the FASB staff and TRG concluded that how an entity accounts for a particular contract under legacy GAAP has no influence on how it should account for that contract under ASC 606. An entity that manufactures goods to its customers' specifications should evaluate each of its contracts to determine whether they meet one or more of the criteria in ASC 606 that require revenue recognition over time. If so, revenue for that contract is recognized over time under ASC 606 even if revenue is recognized at a point in time under legacy GAAP. If not, revenue for that contract is recognized at a point in time regardless of how revenue is recognized under legacy GAAP. Consider the following example.

Example 9-1: Determining whether a performance obligation for goods manufactured to a customer's specifications is satisfied over time or at a point in time (Question 54 of the FASB RRI Q&As)

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.

RSM COMMENTARY: The focus of this example is whether the series exception applies because this example originally was developed by the FASB staff for that purpose. The series exception applies when two criteria are met (see Section 6.3), one of which is when each distinct promised good or service in a series of distinct promised goods or services would otherwise be considered a performance obligation that is satisfied over time (because it meets one of the three criteria to be considered satisfied over time). As a result, in reaching a conclusion about whether the series exception applies in this example, the FASB staff and TRG also had to reach a conclusion that the production of each unit is a distinct service that would be satisfied over time because it meets the third criterion to be considered satisfied over time (i.e., no alternative use and an enforceable right to payment). While more facts would be needed to reach a final conclusion under legacy GAAP, the FASB staff and TRG provided this example as a situation in which the entity likely would recognize revenue at a point in time (e.g., upon delivery of each unit to the customer) under legacy GAAP, but over time under ASC 606.

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This example should not be taken to mean that every performance obligation that includes manufacturing a product or providing a service that meets the customer's specifications should be considered satisfied over time. Such performance obligations should only be considered satisfied over time if they meet one of the three applicable criteria.



Spotlight on change

The general revenue recognition guidance in legacy GAAP did not provide a model for determining whether revenue should be recognized at a point in time or over time. Entities essentially had to make this determination when they apply the general revenue recognition criteria to a transaction. Having specific guidance in ASC 606 related to making this determination could change an entity's conclusion as to whether revenue for a particular contract or unit of account should be recognized over time or at a point in time. This is particularly true with respect to service transactions, given the lack of guidance on this subject in legacy GAAP. It should not be assumed that application of ASC 606 will result in the recognition of revenue for service transactions over time. Whether that is the case will require the entity to carefully consider whether a performance obligation that includes a promised service meets one of the three criteria that results in the recognition of revenue over time.

In addition, while the revenue recognition guidance in legacy GAAP for construction-type and production-type contracts provided guidance about whether the percentage-of-completion method (which results in recognizing revenue over time) or completed-contract method (which results in recognizing revenue at a point time) should be used to recognize revenue, this guidance is significantly different from the guidance in ASC 606 about whether revenue should be recognized over time or at a point in time. Given these significant differences, it is possible that an entity recognizing revenue based on the percentage complete under legacy GAAP for construction-type and production-type contracts may have to change to recognizing revenue at a point in time under ASC 606. An entity will only know if this is the case after carefully considering its facts and circumstances in the context of the guidance in ASC 606.

9.2.1 Customer simultaneously receives and consumes benefits as entity performs

In some situations, it will be readily apparent that the customer is simultaneously receiving and consuming the benefits as the entity performs. Examples of these situations include those in which the entity provides routine or recurring services, such as monthly payroll processing services or a one-year health club membership. Situations in which the entity's performance results in the creation or enhancement of an asset do not also result in the benefits of the entity's performance being simultaneously received and consumed by the customer. For those situations in which the entity's performance creates or enhances an asset, the entity should consider whether one of the other two criteria are met (see Section 9.2.2 and Section 9.2.3).

If it is not readily apparent whether the customer simultaneously receives and consumes benefits as the entity performs in a particular situation, then a performance obligation is satisfied over time if another entity could step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity. In making this determination, the entity should not consider the effects of any potential contract restrictions or practical limitations (which include setup activities that would need to be performed by the other entity to continue to provide the ongoing service) on its ability to transfer the partially satisfied performance obligation to another entity for completion. In addition, the entity should assume that it would continue to control any assets it is using in satisfying the performance obligation if the partially satisfied performance obligation were transferred to another entity for completion. In other words, the entity should not assume that one or more of the assets it uses to

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satisfy the performance obligation would or could be transferred to another entity to facilitate its completion of the performance obligation. Consider the following example and Example 9-6.



Example 9-2: Determining whether the customer simultaneously receives and consumes benefits as the entity provides it with payroll processing services (ASC 606-10-55-159 to 55-160)

An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

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.



RSM COMMENTARY: This example includes setup activities that would need to be undertaken by another entity to continue to provide payroll processing services. This is a practical limitation that should not be considered by the entity in determining whether the other entity could step in and fulfill the remaining payroll processing performance obligation without having to substantially reperform the work already performed by the entity.

9.2.2 Customer controls the asset as the entity creates or enhances the asset

An entity will need to carefully consider the indicators of control discussed in Section 9.1 in assessing whether control of the asset (which could be tangible or intangible) passes to the customer as the entity performs. An example of a performance obligation that might meet this criterion, depending on the relevant facts and circumstances, is a construction contract in which the entity is building a hospital on land owned by the customer (see Example 9-10).



Example 9-3: Determining whether the customer controls the asset enhanced by the entity's performance

Company A enters into a contract with Customer B to paint Customer B's airplane hangar. Company A concludes the contract includes one performance obligation.

As Company A performs and paints the airplane hangar, it is enhancing an asset Customer B controls. As a result, Company A concludes that the performance obligation to paint the airplane hangar is satisfied over time.

9.2.3 No alternative use and an enforceable right to payment for performance to date

For this criterion to be met, the entity must conclude that: (a) the asset created by its performance does not have an alternative use to it upon completion of the asset and (b) it has an enforceable right to payment for its performance to date. The assessment required to draw a conclusion as to whether this

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criterion is met is only reperformed after contract inception if the performance obligation is substantively changed by a subsequent contract modification.

Identifying an appropriate measurement of progress toward complete satisfaction of a performance obligation could be complex when the entity is recognizing revenue over time because the asset has no alternative use and the right to payment for performance to date is enforceable. In these situations, the entity should consider whether there being no alternative use and (or) an enforceable right to payment for performance completed to date effectively results in control of the entity's performance to date transferring to the customer.

9.2.3.1 No alternative use

In performing the assessment as to whether the asset has an alternative use to the entity, an entity needs to determine the nature and substance of any legal, contractual or practical limitations on its ability to redirect (e.g., sell to another customer) the completed asset created by its performance. The asset does not have an alternative future use to the entity if the entity is either contractually restricted or practically limited from directing the asset for another use. For this purpose:

- *Contractual restriction*. A contractual restriction must be substantive and enforceable. In other words, to conclude that the asset has no alternative use to the entity, the customer must be able to enforce its right to obtain the asset if the entity tries to use it for another purpose. In addition, that right must be meaningful, which would not be the case if the asset in question is readily interchangeable with other assets that the entity could use to satisfy its obligation to the customer without putting it in breach of contract or causing it to incur significant incremental costs.
- *Practical limitation*. If a practical limitation would result in an entity experiencing significant economic losses as a result of redirecting the asset for another use, the asset has no alternative use to the entity. Examples of situations in which an entity could experience significant economic losses when trying to redirect the asset for another use include: (a) incurring significant costs to rework an asset because it was built to the original customer's specifications and (b) selling the asset for a significant loss because it had to be moved from the remote area in which it was built as specifically requested by the original customer.

In addition, when assessing whether it could redirect the asset for another use, the entity does not consider the possibility that the contract could be terminated.



Example 9-4: Determining whether a satellite has an alternative use to the entity (ASC 606-10-55-165 to 55-168)

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.

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.

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.

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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.



RSM COMMENTARY: As mentioned in the example, to recognize revenue over time, the entity also must determine whether it has an enforceable right to payment that is proportionate to its performance to date in the event the customer or another party terminates the contract for reasons other than the entity not performing as promised. Given the stark difference in how revenue is recognized depending on the conclusion reached (over time as the satellite is built vs. the point in time control of the satellite transfers to the customer), the entity would carefully consider the relevant contract terms and other facts and circumstances (e.g., legal precedent that could override the contract terms) that could affect whether it has the necessary enforceable right to payment.

Example 9-6 and Case B of Example 9-7 also discuss whether the promised good or service underlying a performance obligation has an alternative use to the entity.

9Q.2.3.1.1 In evaluating whether an asset has no alternative use, should an entity consider the asset in its completed state or the in-production asset?

The evaluation should consider the asset in its completed state. This issue was addressed in Question 55 of the FASB RRI Q&As. Further support for this conclusion in included in paragraph BC136 of ASU 2014-09, which states: "In assessing whether the asset has an alternative use, the entity would need to consider practical limitations and contractual restrictions on directing the asset for another use. In determining whether the entity is limited practically from directing the asset for another use, the Boards decided that an entity should consider the characteristics of the asset that will ultimately be transferred to the customer."

9.2.3.2 Enforceable right to payment for performance to date

In performing the assessment as to whether an enforceable right to payment for performance to date exists, the entity must be able to conclude, based on the terms of the contract and applicable laws, that it is entitled to proportionate compensation for its performance to date at all times during the contract if the contract were to be terminated by the customer or another party for reasons other than the entity not performing as promised. For this purpose: (a) an entity is not necessarily required to conclude that it has a present unconditional right to payment and (b) the amount to which the entity is entitled does not have to be a fixed amount.

To draw an appropriate conclusion with respect to whether the entity has an enforceable right to payment (by either demanding payment or retaining payment) for its performance completed to date if the contract were to be terminated by the customer or another party for reasons other than the entity not performing as promised, the entity should ensure it has a complete understanding of all the relevant facts and circumstances, which could include:

- The contract terms dictating the circumstances under which the entity has an enforceable right to payment and the circumstances under which the customer has the right to terminate the contract.
- Any legislation, legal precedent or administrative practice that would negate the binding effect of contract terms that would otherwise provide the entity with a right to payment for its performance completed to date.

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- Whether the entity has any customary business practices related to not enforcing its contractual right to payment for performance completed to date that would render unenforceable its contractual right to payment for performance completed to date.
- Any contractual provision or law that may result in the entity having an enforceable right to payment for both of the following if the customer terminates the contract when it does not have a right to do so or otherwise fails to perform as promised: (a) the entity's performance completed to date and (b) the entity's remaining performance to fully satisfy its contractual obligation.
- Whether the customer's payment schedule in the contract has any bearing on whether the entity has an enforceable right to payment for its performance to date.
- Circumstances under which the entity would have to refund amounts paid by (or due from) the customer other than those circumstances related to the entity not performing as promised.

For contracts that do not specify whether the entity has a right to payment upon termination, the FASB staff clarified in Question 57 of the FASB RRI Q&As that it does not expect entities to analyze every law in every jurisdiction to determine whether there is a right to payment upon termination. Rather, the FASB staff's view is that when a contract's terms do not specify a right to payment upon contract termination, entities can presume that such a right does not exist.

Conversely, if the terms of the contract do not specify whether the entity has a right to payment upon contract termination and the entity asserts that it has an enforceable right to payment for performance completed to date, an entity would be expected to support this assertion based on legislation, administrative practice or legal precedent in the relevant jurisdiction. This would include evaluating whether any relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have a binding legal effect. Additionally, 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 that there is an enforceable right to payment.

Only after understanding all the relevant facts and circumstances will an entity be in a position to conclude that it has (or does not have) an enforceable right to payment for performance completed to date if the contract were terminated by the customer or another party for reasons other than the entity not performing as promised.

It is not only a matter of the entity having an enforceable right to payment for its performance completed to date. The payment itself must represent proportionate compensation for the entity's performance. Proportionate compensation would be an amount that is roughly equivalent to what the selling price would be for what the entity has completed to date. ASC 606-10-55-11 indicates the following:

> 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.

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If a performance obligation is part of a contract priced at a loss, the entity has an enforceable right to payment for its performance to date if it is entitled to a proportionate amount of the performance obligation's selling price.

9Q.2.3.2.1 Does an enforceable right to payment for performance to date exist in contracts in which an entity receives an upfront nonrefundable payment equal to the transaction price?

Yes, if the right to retain the upfront payment on contract termination by the customer is enforceable. The FASB stated in paragraph BC146 of ASU 2014-09 that: "A few respondents asked whether a 100 percent nonrefundable upfront payment would meet the "right to payment for performance completed to date" criterion (that is, because a 100 percent payment would at least compensate the entity for work completed to date throughout the contract). The Boards decided that that type of payment would meet that criterion if the entity's right to retain (and not refund) that payment would be enforceable if the customer terminated the contract."

9Q.2.3.2.2 Does an enforceable right to payment for performance to date exist in contracts with the U.S. federal government with terms governed by Federal Acquisition Regulations?

Yes. As discussed in Question 5Q.3.1, contracts with the U.S. federal government ("government") are generally governed by the terms in the Federal Acquisition Regulations (FAR). FAR allows the government to terminate a contract at any point in time for convenience. FAR Subpart 49.2 addresses the general principles for determining the settlement amounts for fixed-price contracts terminated for convenience. On termination of a contract for convenience by the government, FAR stipulates that the entity should be compensated fairly for both the work performed and preparations for the terminated portions of the contract. This would include compensation for the costs incurred on work performed and costs incurred for the terminated portions of the contract, including costs that may not otherwise have been incurred without termination, plus a reasonable profit allowance.

We believe the termination for convenience clause and related settlement provision of FAR support that an enforceable right to payment for performance to date exists as the entity is entitled to proportionate compensation for its performance to date at all times during the contract if the contract were terminated by the government for reasons other than the entity not performing as promised. In these situations, an entity would still be required to evaluate whether an asset has no alternative use as discussed in Section 9.2.3.1 to determine whether revenue can be recognized over time.



Example 9-5: Determining whether an enforceable right to payment for performance completed to date exists when there is a payment schedule (ASC 606-10-55-169 to 55-172)

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.

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.

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

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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.

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 9-6: Determining whether a performance obligation made up of consulting services is satisfied over time or at a point in time (ASC 606-10-55-161 to 55-164)

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.

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.

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.

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.

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RSM COMMENTARY: Only two of the three factors related to whether revenue should be recognized over time or at a point in time were addressed in this example. The third factor (ASC 606-10-25-27[b]) is not met in this example because the customer does not control the output of the consulting services until it is provided with the opinion by the entity.

In most situations in which an entity provides client-specific consulting services it will conclude that its performance is not creating an asset with an alternative use to the entity if the contract were terminated by the customer or another entity for reasons other than the entity not performing as promised. To recognize revenue over time in these situations (including the situation illustrated in this example), the entity also must determine whether it has an enforceable right to payment that is proportionate to its performance to date in the event the customer or another party terminates the contract for reasons other than the entity not performing as promised. Drawing an inappropriate conclusion with respect to whether the entity has the necessary enforceable right to payment could result in the entity erroneously concluding that revenue should be recognized over time as the consulting services are provided instead of at the point in time control of the opinion transfers to the customer (or vice versa). Given the stark difference in how revenue is recognized depending on the conclusion reached, the entity should carefully consider the relevant contract terms and other facts and circumstances (e.g., legal precedent that could override the contract terms) that could affect whether it has the necessary enforceable right to payment.



Example 9-7: Determining whether a performance obligation made up of the sale of a unit in a multi-unit residential complex is satisfied over time or at a point in time (ASC 606-10-55-173 to 55-182)

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A—Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date

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.

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.

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Case B—Entity Has an Enforceable Right to Payment for Performance Completed to Date

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.

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.

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.

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.

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

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.

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.

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RSM COMMENTARY: In Case A, only one of the three factors related to whether revenue should be recognized over time or at a point in time is addressed. The other two factors (ASC 606-10-25-27[a] and 25-27[b]) are not met in this example because: (a) the customer is not consuming the entity's construction of the unit as the entity is building the unit and (b) the customer does not control the output of the construction services (i.e., the unit) until it obtains ownership of the unit at or near the end of the construction process.

In Cases B and C, it is important to note that the conclusion that the entity has an enforceable right to payment for performance completed to date hinges on the entity having the right to compel the customer to perform in the event of customer default, not on whether the entity would expect to exercise that right.

9.3 Recognizing revenue for performance obligations satisfied over time

If the performance obligation is considered satisfied over time, the related revenue is recognized over time if the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. In the unlikely scenario that an entity is unable to reasonably measure the outcome of a performance obligation, such as in the early stages of a long-term contract, it should recognize revenue to the extent of the costs incurred to satisfy the performance obligation, but only if it expects to recover those costs. This approach is expected to be used only rarely and only until the entity is able to reasonably measure the outcome of a performance obligation.

In situations in which the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation, it must identify a single method by which to make that measurement. The objective of this method should be to measure the progress made in transferring control of the underlying goods or services to the customer. Important considerations in identifying that single method include whether the method:

- Takes into consideration the nature of the underlying promised goods or services
- Provides a reasonable estimate of the entity's progress toward complete satisfaction of the performance obligation using reliable information
- Is consistent with how control of the underlying goods or services is transferred to the customer

Output methods or input methods can be used to measure progress toward complete satisfaction of performance obligations. Regardless of which is used, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the underlying goods or services for which control has transferred to the customer and should not reflect any underlying goods or services for which control has not transferred to the customer. In addition, once a method is selected, it should be consistently applied to similar performance obligations in similar circumstances.

Progress toward completion is calculated at the end of each reporting period and used in determining the appropriate amount of revenue to recognize in that period. The calculation is based on the amount of outputs or inputs to date and the estimated total amount of outputs or inputs necessary to satisfy the performance obligation. Prior to measuring progress toward completion at the end of a reporting period, the entity should consider whether the estimated total amount of outputs or inputs necessary to satisfy the performance obligation should be updated. Any updates to the estimates not caused by a contract modification or certain other factors (e.g., significant unexpected inefficiencies experienced by the entity [see Section 9.3.2]) should be accounted for as a change in estimate in accordance with ASC 250.

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The following questions are based on discussions of the FASB staff and TRG about measuring progress toward the complete satisfaction of a performance obligation. This issue was addressed in Question 51 of the FASB RRI Q&As.

9Q.3.1 If control of the underlying goods or services in a performance obligation transfers to the customer at discrete points in time, can that performance obligation be considered one that is satisfied over time?

No. The FASB staff and TRG concluded it would not be possible to meet any of the criteria that would result in a performance obligation being considered one that is satisfied over time if control of the performance obligation's underlying goods or services transfers to the customer at discrete points in time. As a result, if control of the performance obligation's underlying goods or services transfers to the customer at discrete points in time, the performance obligation is considered one that is satisfied at a point in time.

9Q.3.2 Are there situations in which applying a method to measure progress could result in recognizing work in process (or a similar asset)?

Generally, no. The FASB staff and TRG concluded that work in process or a similar asset should generally not result from applying a method to measure progress toward complete satisfaction of a performance obligation satisfied over time. This is a natural progression from the conclusion that a performance obligation cannot be considered satisfied over time if control of the underlying goods or services transfers to the customer at discrete points in time (see the previous question) because the only time such an asset would come into existence would be between those discrete points in time.



Spotlight on change

The general revenue recognition guidance in legacy GAAP did not provide much guidance on determining the method by which to measure an entity's progress in completing the earnings process for a unit of account for which revenue is recognized over time. An entity essentially had to make this determination when it applied the general revenue recognition criteria to a transaction and consider the manner in which the entity completed the earnings process for a unit of account. Having specific guidance in ASC 606 related to making this determination could change an entity's conclusion as to the manner in which revenue for a particular unit of account (i.e., performance obligation under ASC 606) in a contract should be recognized. This is particularly true with respect to service transactions, given the lack of guidance on this subject in legacy GAAP.

The revenue recognition guidance in legacy GAAP for construction-type and production-type contracts provided guidance on when the percentage-of-completion method or completed contract method should have been used to recognize revenue for contracts within its scope. However, the basis for using one method or the other under legacy GAAP is different from the basis for recognizing revenue over time or at a point in time under ASC 606. In addition, while there are some similarities between the percentage-of-completion method in legacy GAAP and recognizing revenue over time under ASC 606, there also are some potentially significant differences. For example, while a cost-to-cost method of measuring progress toward the complete satisfaction of a performance obligation is still allowed under ASC 606, it would no longer be appropriate to use that method when it is not consistent with how control of the underlying goods or services is transferred to the customer. For another example, legacy GAAP allowed an entity to apply the percentage-of-completion method using one of two approaches: (a) recognizing revenue based on the percentage complete and contract costs as they are incurred or (b) recognizing revenue and contract costs based on the percentage complete. While the first of these approaches is fairly consistent with recognizing revenue over time under ASC 606, the second of these approaches would not be appropriate under ASC

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606. For all these reasons and others, entities that apply legacy GAAP for construction-type and production-type contracts could experience potentially significant changes in how they recognize revenue.

9.3.1 Output methods

Output methods rely on the value of the underlying goods or services included in the performance obligation. Examples of output methods that may be appropriate to apply (depending on the facts and circumstances) include:

- Surveying or appraising the value of the results achieved and comparing that amount to the value of the results expected from satisfying the performance obligation.
- Determining the units produced or units delivered and comparing that amount to the total units included in the performance obligation that are expected to be produced or delivered. (However, as discussed in the next paragraph, care should be exercised in selecting and applying this method.)
- Comparing time elapsed in satisfying the performance obligation with the time period over which the performance obligation is satisfied.
- Identifying the milestones reached and comparing those milestones to all of the milestones that must be reached in connection with satisfying the performance obligation. (However, as discussed in the next paragraph, care should be exercised in selecting and applying this method.)

A particular output method should only be used if the measure of progress it produces is consistent with how control of the goods or services transfers to the customer. As a result, care should be exercised to ensure an output method reflects all of the goods or services in the performance obligation for which control has transferred to the customer (even those goods or services that are partially completed). For example, if an entity plans to use a units-produced or units-delivered method, it should ensure that method takes into consideration any work in process at the beginning of the reporting period for which control transferred to the customer in the previous reporting period and any work in process at the end of the reporting period for which control transferred to the customer in the current reporting period. If the units-produced or units-delivered method does not appropriately consider work in process for which control has transferred to the customer at the end of a reporting period, it should not be used to measure the entity's revenue. As discussed in paragraph 11.5.08 of the Revenue Recognition AAG, for contracts that include a termination for convenience clause that gives a customer effective control over the goods produced and work in process, a units-delivered or units-produced output method would not be appropriate as it would ignore the work in process that belongs to the customer. Further, as discussed in paragraph 11.5.18 of the Revenue Recognition AAG, a units-delivered or units-produced output method also may not be appropriate for contracts to provide design and production services as equal value is not delivered to the customer with each unit. However, as noted in paragraph 11.5.20 of the Revenue Recognition AAG, a units of delivery method may be appropriate in certain production-only contracts for homogeneous products.

For another example, if an entity plans to use an output method based on milestones, it should ensure that this method correlates to its progress toward complete satisfaction of the performance obligation and transfer of control to the customer. We expect that an output method based on milestones would often not be an appropriate measure of an entity's progress toward complete satisfaction of a performance obligation as there often is work in process inventory created between milestones for which control has passed to the customer (see Question 9Q.3.1 and Question 9Q.3.2).

While an output method that is appropriately identified and utilized would often provide the best theoretical measure of an entity's progress in satisfying a performance obligation, in many cases the outputs of a performance obligation are not directly observable. In addition, identifying the value of the outputs produced for a performance obligation that is only partially satisfied may not be feasible without

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the entity expending undue cost and effort. As a result, input methods are used more often in practice than output methods.

9Q.3.1.1 Does an entity have to reference market or standalone selling prices to determine the value transferred to the customer when using an output method?

No. The FASB answered this question in paragraph BC163 of ASU 2014-09:

> Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (for example, surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units delivered or units produced). When applying an output method, "value to the customer" refers to an objective measure of the entity's performance in the contract. However, value to the customer is not intended to be assessed by reference to the market prices or standalone selling prices of the individual goods or services promised in the contract, nor is it intended to refer to the value that the customer perceives to be embodied in the goods or services.

While *value to the customer* does not require reference to market or standalone selling prices in the context of applying an output method in general, use of *value to the customer* in the context of the practical expedient that allows an entity to recognize revenue for the amount it has a right to invoice the customer might require reference to market or standalone selling prices for the entity's performance to date (see Section 9.3.1.1 and Question 9Q.3.1.1.4).

9.3.1.1 Practical expedient that allows an entity to use an output method that results in it recognizing revenue for the amount it has a right to invoice

A practical expedient allows an entity to use an output method under which revenue is recognized for the amount the entity has a right to invoice the customer if its right to consideration from that customer directly corresponds to the value received by the customer from the entity's performance completed to date. For example, if the contract requires the entity to provide cleaning services to a customer over a period of time, and the customer is obligated to pay the same hourly rate regardless of the nature or timing of the cleaning services provided, the entity could elect this practical expedient. If the practical expedient is elected, the entity does not determine or allocate the transaction price. In addition, certain disclosures are not applicable if the practical expedient is elected. However, as discussed in paragraph 11.5.13 of the Revenue Recognition AAG, recognizing revenue based on the right to invoice the customer may not be appropriate for certain contracts, such as service contracts with a significant variable incentive provision paid by the customer infrequently.

The following questions are based on discussions of the FASB staff and TRG about application of the practical expedient. This issue was addressed in Question 46 of the FASB RRI Q&As.

9Q.3.1.1.1 May an entity apply the practical expedient to contracts with rates that change over the contract term?

The FASB staff and TRG concluded that an entity is not precluded from applying the practical expedient to contracts with rates that change over the contract term. However, whether the practical expedient may be applied to such contracts depends on whether the change in rates over the contract term corresponds with a change in the value of the entity's performance over the contract term. Consider the following two examples.



Example 9-8: Determining whether the practical expedient that allows an entity to recognize revenue for the amount it has a right to invoice applies when rates change over the contract term (Question 46 of the FASB RRI Q&As)

Example A: Power Seller and Power Buyer execute a contract for the purchase and sale of electricity over a 6 year term. Power Buyer is obligated to purchase 10 megawatts (MW) of electricity per hour for

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each hour during the contract term (87,600 MWh per annual period) at prices that contemplate the forward market price of electricity at contract inception. The contract prices are as follows:

- Years 1-2: $50/MWh
- Years 3-4: $55/MWh
- Years 5-6: $60/MWh

The transaction price, which represents the amount of consideration to which Power Seller expects to be entitled in exchange for transferring electricity to Power Buyer, is $28,908,000 (annual contract prices per MWh multiplied by annual contract quantities). Power Seller concludes that the promise to sell electricity represents one performance obligation that will be satisfied over time.

Example B: IT Seller and IT Buyer execute a 10 year IT Outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the vendor will provide server capacity, manage the customer's software portfolio and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity.

IT Seller concludes that each of the activities described will be satisfied over time. Although each activity has a contractual minimum, the IT Buyer is expected to exceed that minimum. Therefore, the IT Buyer pays the IT Seller the relevant price per unit.

The agreed upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller's price.

The FASB staff and TRG concluded that Example A qualifies for the practical expedient because the change in the rate per MW hour over the contract term corresponds with a change in the value of the electricity that will be transferred by Power Seller to Power Buyer over the contract term.

The FASB staff and TRG also concluded that Example B qualifies for the practical expedient because the change in the price per unit of outsourced IT activities over the contract term corresponds with a change in the value of the outsourced IT services that will be transferred by IT Seller to IT Buyer over the contract term.

9Q.3.1.1.2 May an entity apply the practical expedient to contracts that include a single performance obligation made up of a series of distinct goods or services?

The FASB staff and TRG concluded that an entity is not precluded from applying the practical expedient to contracts that include a single performance obligation made up of a series of distinct goods or services as a result of applying the series exception (see Section 6.3). However, whether the practical expedient may be applied to such contracts depends on whether the amount of consideration the entity has a right to receive directly corresponds to the value to the customer of the distinct goods or services transferred by the entity to date.

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9Q.3.1.1.3 May an entity apply the practical expedient to contracts that include a specified minimum amount of consideration or volume discounts?

The FASB staff and TRG concluded that the existence of a specified minimum amount of consideration or volume discounts does not preclude use of the practical expedient by the entity. However, the specified minimum amount of consideration or volume discount would have to be considered nonsubstantive such that the customer is still paying a price per unit (e.g., product, hour). In addition, that price per unit must directly correspond to the value to the customer of the entity's performance to date. Example B in Example 9-8 illustrates a situation in which there is a contractual minimum the customer must pay, but the entity concludes that minimum is nonsubstantive because there is no question it will be exceeded.

9Q.3.1.1.4 Does an entity have to use market or standalone selling prices to substantiate the value to the customer of the entity's performance to date?

To apply the practical expedient, the entity must conclude that the amount it has a right to invoice the customer (i.e., the amount of consideration it has a right to) directly corresponds to the value to the customer of the entity's performance to date. The FASB staff and TRG concluded that the entity might have to contemplate market or standalone selling prices to understand or substantiate the value to the customer of the entity's performance to date for it to conclude the practical expedient may be used.

9.3.2 Input methods

Input methods rely on the efforts put forth by the entity to satisfy the performance obligation (e.g., labor hours, costs incurred). Examples of input methods that may be appropriate to apply (depending on the facts and circumstances) include:

- Labor hours spent compared to the total labor hours expected to be spent to satisfy the performance obligation
- Costs incurred compared to the total costs expected to be incurred to satisfy the performance obligation
- Machine hours used compared to the total machine hours expected to be used to satisfy the performance obligation
- Time elapsed compared to the total time period over which the performance obligation is satisfied

When using an input method, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the inputs related to the underlying goods or services for which control transfers to the customer and should not reflect the inputs related to the underlying goods or services for which control has not transferred to the customer. As a result, an input method should not reflect inputs that relate to activities that are not themselves goods or services, such as setup activities (see Section 6.1.4). Consider the following example.



Example 9-9: Identifying a method to measure progress toward complete satisfaction of a performance obligation made up of a software as a service solution (Question 48 of the FASB RRI Q&As)

A cloud computing company provides software as a service solutions to its customers. The typical arrangement includes promises for access to hosted software for one year and upfront implementation services. The one-year hosting period begins when the implementation is complete, and the customer cannot access or utilize the service until this time.

The implementation services are typically performed over a 3-month period. The vendor's solution is proprietary, and no other vendors are capable of performing the implementation. Furthermore, the customer cannot derive benefit from the implementation or the hosting service until the implementation is

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complete. For the purpose of this example, it is assumed that the entity concludes the implementation services are not capable of being distinct from the hosting. Assume the entity concludes there is no material right for future renewals.

Assume that the total transaction price is CU 1,100, and the direct costs that would be used in the cost to cost input method is CU80 for implementation and CU200 for the hosting service.

In the staff's view, the entity should use a measure of progress that depicts the performance of the hosting services beginning when the hosting service commences. The nature of the entity's overall promise (and, therefore, combined performance obligation) is to provide the hosting service, and no revenue would be recognized over the implementation period because that promise does not transfer a service to a customer. The entity would select a method that depicts the performance of the hosting services to measure progress toward completion. For example, a time-based method might be considered appropriate. The entity would need to consider whether it meets the criteria to capitalize the costs of implementation in accordance with paragraph 340-40-25-5.



RSM COMMENTARY: Views that were rejected by the FASB staff and TRG included ones that would have reflected the implementation activities in the measure of progress toward complete satisfaction of the performance obligation either by using an input method (such as labor hours expended) or a ratable recognition method that starts when the entity begins to carry out the implementation activities. These views were rejected because they would result in recognizing revenue for the implementation activities, which are activities that are incapable of being distinct because the customer cannot benefit from them either on their own or together with other readily available resources. In other words, the implementation activities are like setup activities, which do not transfer a promised good or service to the customer in and of themselves.

Accounting for SaaS arrangements is discussed in Question 10Q.1.2.

In some situations, there might not be a direct relationship between the inputs expended by an entity and the amount of underlying goods or services for which control has transferred to the customer. In these situations, the entity must determine whether it can adjust the input method to correct for the lack of a direct relationship or whether it should use a different input method or an output method. For example, if an entity is using a cost-to-cost method of measuring its progress toward the complete satisfaction of a performance obligation and incurs a cost that ultimately does not contribute to satisfying the performance obligation, the entity should remove that cost from both the numerator and denominator of the cost-to-cost measure. Costs that ultimately do not contribute to satisfying the performance obligation may be caused by significant unexpected inefficiencies in the entity's performance (e.g., wasted labor, material, other resources) that were not included in the entity's contract price. As discussed in paragraphs BC176 to BC178 of ASU 2014-09, the FASB considered providing guidance for identifying the costs related to inefficiencies and wasted materials that should be excluded from a cost-to-cost method of measuring progress, but ultimately decided it was not feasible to do so. This makes it clear that an entity will have to exercise significant judgment and carefully consider all the facts and circumstances to properly identify those costs that should be excluded from a cost-to-cost measure of progress. When making a judgment in this regard, an entity should ensure it is consistent with the overall objective to measure the entity's performance in the contract and that it is consistent with other judgments it has made in similar situations.

Adjusting a cost-to-cost measure when there is a cost incurred by the entity that is not proportionate to its progress in satisfying the related performance obligation (i.e., uninstalled materials) is discussed in Section 9.3.2.1.

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Example 9-10: Applying a cost-to-cost input method or an output method to the construction of a hospital with a change in the estimate of total costs

Company A enters into a contract with Customer B on September 1, 20X1 to build a new hospital for $100 million. Company A expects construction of the hospital to take approximately three years, and it estimates it will incur construction costs totaling $85 million. The schedule by which Company A bills the $100 million transaction price is as follows:

Billing date	20X1	20X2	20X3	20X4
March 1	$ -	$7,000,000	$7,000,000	$7,000,000
June 1	-	7,000,000	7,000,000	7,000,000
September 1	7,000,000	7,000,000	7,000,000	16,000,000
December 1	7,000,000	7,000,000	7,000,000	-
Annual total	$14,000,000	$28,000,000	$28,000,000	$30,000,000
Contract total				$100,000,000

Customer B is obligated to pay the amounts billed by Company A within 60 days of the billing date.

Customer B already owns the land on which the hospital will be built. Based on its facts and circumstances, Company A concludes the contract includes a single performance obligation (see Example 6-7). Company A also concludes the contract is satisfied over time because control of the hospital transfers to Customer B as it is built by Company A.

Case 1: Cost-to-cost method

Company A decides it will use a cost-to-cost method to measure its progress toward completion of the hospital because:

- Company A has reliable information about the costs it expects to incur and the costs it actually incurs, which will enable it to reasonably measure its progress toward completion of the hospital.
- Company A concludes using a cost-to-cost method will measure its progress in transferring control of the hospital to Customer B because as Company A incurs costs to build the hospital, control of what is built with those costs transfers to Customer B.

In addition, Company A uses a cost-to-cost method to measure progress toward the complete satisfaction of other performance obligations similar to the one in its contract with Customer B.

As of December 31, 20X1 (its calendar year end), Company A has: (a) incurred construction costs of $8.5 million, (b) received the September 1 payment of $7 million from Customer B and (c) not yet received the December 1 payment of $7 million from Customer B. In addition, Company A continues to estimate that it will incur total costs of $85 million.

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The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	$7,000,000	
Accounts receivable	7,000,000	
Costs of construction	8,500,000	
Revenue (Note 1)		$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: $100,000,000 transaction price × ($8,500,000 construction costs incurred ÷ $85,000,000 total construction costs expected to be incurred)

Note 2: The contract liability represents the difference between: (a) Customer B's performance ($7 million payment) and obligation to perform ($7 million obligation to pay) and (b) Company A's performance ($10 million) (see Section 14.2).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

During the first quarter of 20X2, Company A increases its estimate of total construction costs by $3 million, which consists of:

- $2 million of additional materials costs due to an unanticipated increase in certain construction materials.
- $1 million of foundation rework resulting from subpar workmanship on Company A's part.

As a result, Company A estimates its total construction costs to be $88 million. Company A has not yet decided whether it will seek a contract modification from Customer B to increase its fee for building the hospital to cover these costs. As of March 31, 20X2, Company A has: (a) incurred total construction costs to date of $16,660,000 (which includes the $1 million foundation rework costs), (b) received the December 1, 20X1 payment of $7 million from Customer B and (c) not yet received the March 1, 20X2 payment of $7 million from Customer B.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	$7,000,000	
Costs of construction (Note 1)	8,160,000	
Contract liability (Note 2)	1,000,000	
Revenue (Note 3)		$8,000,000
Accounts payable (Note 4)		8,160,000

Note 1: $16,660,000 total construction costs incurred – $8,500,000 construction costs incurred in prior periods

Note 2: The balance in the contract liability should be $3 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and (b) Company A's performance of $18 million ($10,000,000 of revenue recognized

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in 20X1 + $8,000,000 of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by $1 million.

Note 3: ($100,000,000 transaction price × [($16,660,000 total construction costs incurred – $1,000,000 for foundation rework) ÷ ($88,000,000 total construction costs expected to be incurred – $1,000,000 for foundation rework)]) – $10,000,000 recognized as revenue in prior periods. The foundation rework costs are eliminated from the cost-to-cost measure of progress toward complete satisfaction of the performance obligation because they are duplicative costs that do not incrementally contribute to satisfying the performance obligation.

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8,160,000 of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

Case 2: Output method

Customer B issued bonds to pay for the hospital being built by Company A. The bond covenants require Customer B to obtain an appraisal of the work performed by Company A as of each quarter end, starting with December 31, 20X1. Customer B's contract with Company A requires it to share those appraisals with Company A upon receipt from the appraiser. As a result, Company A decides to use the appraisals to measure its progress toward complete satisfaction of the performance obligation. Company A concludes using an output method based on appraised value will measure its progress in transferring control of the hospital to Customer B because as Company A performs and increases the value of the hospital, control of the hospital (and underlying value) transfers to Customer B.

The costs incurred and payments received as of December 31, 20X1 are the same as Case 1. In addition, the appraisal obtained by Customer B as of December 31, 20X1 indicates the value of the hospital is expected to be $100 million upon completion, and the value of the construction in process is $10 million.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	$7,000,000	
Accounts receivable	7,000,000	
Costs of construction	8,500,000	
Revenue (Note 1)		$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: $100,000,000 transaction price × ($10,000,000 appraised value of the construction in process at December 31, 20X1 ÷ $100,000,000 appraised expected value of hospital upon completion)

Note 2: The contract liability represents the difference between: (a) Customer B's performance ($7 million payment) and obligation to perform ($7 million) and (b) Company A's performance ($10 million) (see Section 14.2).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

The costs incurred and payments received as of March 31, 20X2 are the same as Case 1. In addition, the appraisal obtained by Customer B as of March 31, 20X2 indicates the value of the hospital is expected to be $102 million upon completion and the value of the construction in process is $18,360,000.

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The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	$7,000,000	
Costs of construction (Note 1)	8,160,000	
Contract liability (Note 2)	1,000,000	
Revenue (Note 3)		$8,000,000
Accounts payable (Note 4)		8,160,000

Note 1: $16,660,000 total construction costs incurred – $8,500,000 construction costs incurred in prior periods

Note 2: The balance in the contract liability should be $3 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and (b) Company A's performance of $18 million ($10,000,000 of revenue recognized in 20X1 + $8,000,000 of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by $1 million.

Note 3: ($100,000,000 transaction price × [$18,360,000 appraised value of the construction in process at March 31, 20X2 ÷ $102,000,000 appraised expected value of hospital upon completion) – $10,000,000 recognized as revenue in prior periods.

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8,160,000 of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

For ease of illustration, the percentages complete at December 31, 20X1 and March 31, 20X2 were the same as those in Case 1. While the expectation would be that the percentages complete under an input method and output method would be similar (all other things being equal) given that the objective of both is the same, the actual percentages complete may not necessarily be the same.

9Q.3.2.1 Under what circumstances is it appropriate to recognize revenue on a straight-line basis?

Recognizing revenue ratably over time on a straight-line basis is appropriate if control of the goods or services underlying the performance obligation transfers to the customer ratably over time. This is typically the case when the entity puts forth a consistent amount of effort and input over the performance period.



Example 9-11: Identifying a method to measure progress to completion for a performance obligation made up of a health club membership (ASC 606-10-55-184 to 55-186)

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.

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.

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Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a).

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.

9.3.2.1 Applying a cost-based input method when there are uninstalled materials

Applying a cost-based input method presents a challenge when costs incurred by the entity are not proportionate to the progress it has made in satisfying the related performance obligation. For example, in a typical construction project, goods procured from third parties generally are procured on an as-needed basis, preferably soon before integrating them into the project. These goods can range from standard items, such as steel, concrete or aluminum, to more customized items, such as piping configured in a unique manner for a particular project. In situations where significant materials arrive far in advance of installation, applying a cost-based input method that includes these costs could result in an entity overstating its progress toward satisfying the performance obligation, resulting in inappropriate premature revenue recognition. A careful evaluation of the facts and circumstances is required for an entity to evaluate whether it should exclude certain uninstalled materials from its input method used to measure the entity's progress and recognize revenue equal to those costs (i.e., at a zero margin)

For an entity to reach a conclusion that it should exclude certain uninstalled materials from its input method, it must expect at contract inception that all of the following conditions will be met with respect to the uninstalled materials:

- The materials are not distinct (i.e., they do not represent their own performance obligation[s]).
- A significant period of time will elapse between when the customer obtains control of the materials and when the entity subsequently provides the services related to those materials (e.g., installation).
- The cost of the materials is significant in comparison to the total costs expected to be incurred to satisfy the performance obligation.
- The materials are provided by a third party and the entity is not significantly involved in their design and manufacture; however, the entity is acting as a principal under ASC 606 with respect to providing those materials to the customer (see Chapter 11).

An entity must first determine whether the procured materials are distinct. As noted in paragraph 11.5.32 of the Revenue Recognition AAG, this is not expected to be the case in a typical construction contract but nevertheless must still be evaluated. In situations where materials are not distinct and can be readily used by the entity in fulfilling other construction projects without incurring significant modification costs, the inventoriable materials should be evaluated as an uninstalled material if the customer has obtained control and the remaining three conditions have been met.

If control of the materials has not yet transferred to the customer, these materials would not be considered uninstalled materials and may qualify as an inventoriable cost under ASC 330, "Inventory." An entity will need to evaluate all facts and circumstances regarding delivery of goods as well as internal and external factors to determine whether control has transferred to the customer. For example, unexpected delays caused by weather, force majeure, technical challenges and the like could cause materials to arrive at the job site significantly in advance of the revised installation timing. In this example, the entity may determine that the customer has not obtained control of the goods, even though the goods are

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physically at the job site, if goods can be used on other construction jobs and are inventoriable. This is because the goods consist of steel, concrete and copper wire that can be used for various construction contracts without incurring significant costs. In other situations, control may transfer when the item is installed, or prior to installation, if, for example, a security interest in the materials passes to the owner through billing of the specific materials procured. Evaluation of uninstalled materials should be performed throughout the contract's duration.

The second and third conditions indicate that if a customer is expected to obtain control of a good significantly before receiving the services related to that good (e.g., installing the goods in the project), those costs do not depict the entity's performance in satisfying the single performance obligation, provided the cost of the transferred good is significant relative to the total expected costs. In this situation if all other conditions are met, the costs should be excluded from the entity's measure of progress when applying a cost-based input method until such time that the entity's performance is established.

The last condition indicates that if the entity is significantly involved in the design and manufacture of an item, even if the item is procured from a third-party manufacturer, then procurement of the specifically designed materials would represent progress toward satisfying a performance obligation as it would not meet this condition to be considered an uninstalled material. An example of not meeting this condition would be an integrated construction contractor's design of materials fabricated by a third party, such as prefabricated walls of a nuclear power plant.

In situations where the entity has determined that all four criteria are met and has recognized revenue in an amount equal to the good's cost, the entity should revisit the accounting upon installation of the good to determine whether the revenue recognized best depicts the entity's performance in the contract. As noted in paragraph 11.5.38 of the Revenue Recognition AAG, in certain situations, an entity may conclude that including the costs in the cost-based input method as materials are installed would provide a more faithful depiction of progress toward satisfaction of the performance obligation. In other situations, an entity may conclude that it is most appropriate to exclude the costs from the cost-based input method for the entire duration of the contract, because doing so would best depict the entity's performance under the contract.

Determining whether it is a faithful depiction of the entity's performance to adjust a cost-based input method and recognize revenue to the extent of certain costs incurred will require significant judgment to be exercised and careful consideration of all the facts and circumstances. Consider the following example.



Example 9-12: Determining whether a cost-based input method should be adjusted for uninstalled materials (ASC 606-10-55-187 to 55-192)

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.

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A summary of the transaction price and expected costs is as follows:

Transaction price	$5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	2,500,000
Total expected costs	$4,000,000

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.

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).

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).

Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	$2,200,000 [(a)]
Costs of goods sold	2,000,000 [(b)]
Profit	$200,000 [(b)]

(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.



RSM COMMENTARY: The criteria to recognize revenue for the cost of the elevators (i.e., the uninstalled materials) are met in this example as follows:

- *The materials are not distinct*. The elevators are part of a single performance obligation to provide refurbishment services.
- *A significant period of time will elapse between when the customer obtains control of the materials and when the entity subsequently provides the services related to those materials.* The customer obtains control of the elevators in December 20X2, but the entity will not be installing them until June 20X3.
- *The cost of the materials is significant in comparison to the total costs expected to be incurred to satisfy the performance obligation*. The cost of the elevators ($1.5 million)

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represents 37.5 percent of the total costs to provide the refurbishment services ($4 million), which is clearly significant.

- *The materials are provided by a third party and the entity is not significantly involved in their design or manufacture; however, the entity is acting as a principal under ASC 606 with respect to providing those materials to the customer.* The entity was not involved in the design or manufacture of the elevators. The entity obtains control of the elevators before control of the elevators transfers to the customer. As such, it is a principal under ASC 606 with respect to providing the elevators to the customer (see Chapter 11).



Spotlight on change

In discussing application of a cost-to-cost method of measuring the percentage of a contract that is complete, legacy GAAP for construction-type and production-type contracts discussed uninstalled materials in the context of materials that have been purchased or are at job sites, but that are not unique to the particular project. For these uninstalled materials, legacy GAAP indicated they should be excluded from the costs incurred when measuring the percentage of the project that is complete. As a result, revenue related to the uninstalled materials would have been recognized as the entity otherwise earned revenue on the contract. This approach to uninstalled materials is very different from the approach in ASC 606, which results in the recognition of revenue to the extent of the costs of uninstalled materials when control of the material has transferred to the customer and certain criteria are met, which would likely be before the related revenue would be recognized under legacy GAAP.

9.3.3 Identifying a method to measure progress toward complete satisfaction of a performance obligation made up of multiple promised goods or services that are not distinct

When a promised good or service in a contract is not distinct, it is combined with other promised goods or services in the contract until a bundle of promised goods or services is identified that is distinct (see Section 6.4). The result is a performance obligation made up of multiple promised goods or services. In many cases, these performance obligations will meet one of the criteria that results in recognizing the revenue related to the performance obligation over time. The difficulty that may then arise in these cases is identifying an appropriate method for measuring progress toward the complete satisfaction of the performance obligation. This difficulty was addressed in Questions 47 and 48 of the FASB RRI Q&As.

The FASB staff and TRG concluded that an entity must identify a single method by which to measure progress toward the complete satisfaction of a performance obligation even when the performance obligation is made up of a bundle of promised goods or services. In other words, an entity may not identify different methods to apply to different nondistinct goods or services for purposes of measuring its progress toward the complete satisfaction of the performance obligation as a whole. To do so would likely circumvent the reasons the promised goods or services were bundled together to form one performance obligation in the first place.

In some cases, the multiple promised goods or services in the performance obligation may have the same pattern of transfer to the customer (e.g., two different services provided ratably over the contract term), which should make the selection of a method to measure progress toward the complete satisfaction of the performance obligation relatively straightforward. However, in other cases, the multiple promised goods or services in the performance obligation may have different patterns of transfer to the customer. In these cases, identifying the method to measure progress toward complete satisfaction of the performance obligation may be more difficult.

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An entity should consider the following when identifying an appropriate method in these situations:

- The nature of what the multiple promised goods or services come together to provide the customer.
- The reason(s) why the multiple promised goods or services were combined into one performance obligation.
- Whether any activities will be performed in conjunction with satisfying the performance obligation that are not themselves promised goods or services, and whether those activities have been ignored for purposes of identifying an appropriate method for measuring progress toward the complete satisfaction of the performance obligation (see Section 6.1.4 and Example 9-9).

In addition, in situations in which an entity is finding it particularly difficult to identify a single method for measuring progress toward complete satisfaction of a performance obligation, the FASB staff and TRG suggested that an entity reconsider whether it has identified the appropriate performance obligations in the contract. This does not mean it is a given that the entity has identified inappropriate performance obligations when it is finding it particularly difficult to identify a single method to measure its progress in satisfying a performance obligation. In other words, it may be inherently difficult to identify a single method of measuring progress toward the complete satisfaction of certain appropriately identified performance obligations made up of multiple promised goods or services.

Ultimately, the entity's goal is to identify a method for measuring progress toward the complete satisfaction of a performance obligation that achieves the intended objective, which is to "depict an entity's performance in transferring control of goods or services promised to a customer." Identifying this method will require an entity to exercise significant judgment and carefully consider all the facts circumstances.

9Q.3.3.1 When an entity has performance obligations consisting of multiple promised goods or services that are not distinct, may it adopt an accounting policy under which the measure of progress is based on transferring either the final promised good or service or the predominant promised good or service in the contract?

No. When an entity has performance obligations consisting of multiple promised goods or services that are not distinct, it should not have an accounting policy that will automatically result in the method used to measure progress toward the complete satisfaction of the performance obligation being based on transferring either the final promised good or service or predominant promised good or service in the performance obligation. Each set of facts and circumstances involving a performance obligation consisting of multiple promised goods or services should be carefully evaluated to determine the method that should be used to measure progress toward the complete satisfaction of that performance obligation. While doing so may result in the entity using a method to measure progress toward the complete satisfaction of the performance obligation that is based on the final promised good or service or predominant promised good or service in the performance obligation, neither of those methods can be the default method for whenever an entity has a performance obligation consisting of multiple promised goods or services.



Spotlight on change

Legacy GAAP did not provide guidance on how to recognize revenue for a unit of account that included multiple deliverables, which resulted in diversity in practice. Paragraph 7 of TRG 41 summarizes some of the approaches used in practice under legacy GAAP to recognize revenue for units of account that include multiple deliverables, two of which are:

- The final deliverable model, in which revenue is recognized based on the earnings process for the final deliverable delivered to the customer

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- The predominant deliverable model, in which revenue is recognized based on the earnings process for the predominant deliverable

Whether applying one of these approaches in a specific set of facts and circumstances is appropriate under legacy GAAP depended on the nature of those facts and circumstances.

While applying ASC 606 may provide a result similar to one of these approaches, it would be inappropriate to use one of these approaches to the exclusion of what would otherwise result from the application of ASC 606. As a result, how an entity has recognized revenue under legacy GAAP for a unit of account that includes multiple deliverables likely will change upon application of ASC 606.

9.4 Recognizing revenue for performance obligations satisfied at a point in time

If the performance obligation is considered satisfied at a point in time, the related revenue is recognized at the point in time the entity obtains control of the asset underlying the performance obligation (see Section 9.1).

9.5 Customer's unexercised rights (i.e., breakage)

The contract may provide for the customer to prepay for contractual rights it can exercise in the future. Those rights might entitle the customer to goods and (or) services, which obligates the entity to provide or stand ready to provide those goods or services. The prepayment should be recognized as a contract liability. Revenue is recognized by derecognizing the contract liability when the customer exercises its rights in the future. However, customers do not always exercise all of the rights for which they prepaid. Those rights that go unexercised are referred to as breakage. While one of the most common forms of breakage occurs when gift cards go unredeemed, breakage might occur in a number of other situations as well, including nonrefundable upfront fees, rights for free or discounted products and certain consideration payable to the customer.

To the extent an entity expects to be entitled to an amount of breakage, that amount should be proportionately recognized as revenue as the other performance obligations in the contract (i.e., those contractual rights expected to be exercised by the customer) are satisfied. However, the entity will need to apply the variable consideration constraint and conclude it is probable that a significant reversal in cumulative revenue recognized will not occur as a result of proportionately recognizing breakage as revenue as the other performance obligations in the contract are satisfied. When the entity does not proportionately recognize all breakage as revenue as the other performance obligations in the contract are satisfied (perhaps because of the variable consideration constraint), the transaction price related to that breakage should not be recognized as revenue until the likelihood that the customer will exercise those rights becomes remote. However, when the entity does not expect to be entitled to an amount of breakage because it is required to remit amounts received related to a customer's unexercised rights to another party (e.g., a governmental authority), it should recognize a liability for those amounts.



Example 9-13: Accounting for breakage related to gift cards when it can be reasonably estimated, and there is no escheatment law

While this example addresses the accounting for a single gift card (for ease of illustration), the same approach should be used if an entity elects to account for a portfolio that includes a large volume of similar gift cards (see Section 6.4.1).

Customer B buys a $50 gift card from Company A. The gift card expires in one year, and Company A enforces the expiration date.

Based on its historical data, Company A estimates that Customer B will only use $45 of the gift card and that $5 will go unused. Company A concludes it is probable that recognizing $1.11 of revenue ($50 gift

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card ÷ $45 expected to be redeemed) per $1 of gift card value redeemed will not result in a significant reversal of cumulative revenue recognized when the uncertainty related to how much of the gift card is used before its expiration is resolved. There are no escheatment laws in the state in which the gift card was sold or used that require Company A to pay the state proceeds from the sale of gift cards that go unused.

When Company A sells the gift card to Customer B, it records the following journal entry:

	Debit	Credit
Cash	$50	
Contract liability		$50

When Customer B uses the gift card six months later to purchase shoes for $30, Company A records the following revenue-related journal entry:

	Debit	Credit
Contract liability (Note 1)	$33	
Revenue (Note 1)		$33

Note 1: $30 gift card value redeemed × $1.11 of revenue per $1 gift card value redeemed

Company A still expects $15 of the remaining value on the gift card to be redeemed and the other $5 of the remaining value to expire unused.



Spotlight on change

While ASC 606 provides an explicit model to address breakage, legacy GAAP does not. However, in a speech given in 2005, a member of the SEC staff discussed the following three accounting policies that could have been elected by an entity to recognize revenue for breakage (which would only be appropriate if the entity was not otherwise required to remit amounts related to a customer's unexercised rights to another party [e.g., a governmental authority]):

1. *Breakage model*. Under legacy GAAP, if the amount of breakage is reliably estimable, this model resulted in recognizing breakage proportionately as the customer exercised its other rights in the contract. The breakage model in ASC 606 is consistent with this model in that it provides for recognizing breakage proportionately as the entity satisfies the performance obligations in the contract. However, because breakage is a form of variable consideration under ASC 606, the variable consideration constraint must be applied, which may or may not result in the same amount being recognized as revenue upon the satisfaction of each performance obligation under ASC 606 compared to legacy GAAP.
2. *Remote model*. Under legacy GAAP, this model resulted in recognizing breakage only when there was a remote possibility of the customers exercising their rights. Under ASC 606, if the amount of breakage an entity recognizes proportionately as it satisfies the performance obligations in the contract is constrained, the entity will recognize those constrained amounts of breakage as revenue when the likelihood that the underlying rights will be exercised becomes remote. Those are the only amounts of breakage for which it would be appropriate under ASC 606 to delay revenue recognition until there is a remote possibility of the underlying rights being exercised. In other words, an entity cannot ignore application of the variable consideration guidance in ASC 606 and just default to only

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recognizing breakage when the likelihood that the customers will exercise their underlying rights becomes remote.

3. *Liability derecognition model*. Under legacy GAAP, this model resulted in recognizing breakage as revenue only when the related obligation was extinguished (e.g., when a gift card expires). Under ASC 606, it would be inappropriate to delay revenue recognition until the related obligation is extinguished unless that is the earliest point in time at which the entity is able to conclude the likelihood that the customers will exercise their underlying rights is remote.

Given the accounting policy choice entities had under legacy GAAP and the differences between each of these accounting policies and the breakage model provided in ASC 606, how an entity accounts for breakage recognized as revenue changed at least to some extent under ASC 606.

Legacy GAAP and ASC 606 are consistent with respect to the treatment of amounts related to a customer's unexercised rights that must be remitted to another party (e.g., a governmental authority) in that both require recognition of a liability for the amount that will be remitted to that other party.

9.6 Stand-ready obligations

Identifying stand-ready obligations in a contract and determining whether they are performance obligations is discussed in Section 6.1.3. To the extent a stand-ready obligation exists and it is considered a performance obligation satisfied over time, the entity must identify an appropriate method by which to measure progress toward its complete satisfaction.

How an entity should measure progress toward complete satisfaction of the stand-ready obligation was discussed by the FASB staff and TRG. This issue was addressed in Question 49 of the FASB RRI Q&As, and the FASB staff and TRG concluded that the measure of progress for a stand-ready obligation should be based on its nature and what is required of the entity to satisfy the obligation. In addition, while the FASB staff and TRG acknowledged that a time-based measure of progress may be appropriate for many stand-ready obligations, it would be inappropriate to assume a time-based measure of progress would be appropriate for all stand-ready obligations.

Provided next are examples of stand-ready obligations identified in Example 6-5 and an indication as to whether a time-based method of measuring progress would be appropriate.



Example 9-14: Determining whether a time-based method of measuring progress is appropriate for a stand-ready obligation

The basis for concluding that each promise is a stand-ready obligation is provided in Example 6-5.

Example of stand-ready obligation	Would a time-based measure of progress be appropriate?
Promise to transfer unspecified software upgrade rights over the contract term	The FASB staff and TRG concluded that a time-based measure of progress generally would be appropriate because the stand-ready obligation is essentially a guarantee from which the customer benefits evenly over the period it is in effect.
Promise to provide snow removal services over the contract term	The FASB staff and TRG concluded that a time-based measure of progress is not appropriate because snow removal services are seasonal, which should be reflected in the measure of progress.

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Promise to continuously make the health club available during normal operating hours for the member's use over the membership period	As illustrated in Example 9-11, a time-based measure of progress is appropriate because the customer benefits from the health club being available for its use over the membership period, regardless of how much they use it.
Promise to provide printer repair services over the contract term on an as needed basis	If the entity has no basis to expect that it will provide proportionately more printer repair services in certain time segments of the contract term compared to the other time segments in the contract term, a time-based measure of progress may be appropriate.

9.7 Repurchase agreements (i.e., forwards and call and put options)

Forwards and call and put options are all considered repurchase agreements for accounting purposes. A forward exists when the entity sells an asset to the customer and is obligated to repurchase the asset at some point in the future. A call option exists when the entity sells an asset to the customer and has the option to repurchase the asset at some point in the future. A put option exists when the entity sells an asset to the customer and the customer has the option to require the entity to repurchase the asset at some point in the future. For these purposes, the asset that the entity repurchases or may repurchase can either be the same asset it sold to the customer, a different asset that is substantially the same as the asset it sold to the customer, or a different asset that includes the asset it sold to the customer as a component.

The accounting model applied to a repurchase agreement depends on the nature of the agreement.

9.7.1 Accounting model for forwards and call options

For a forward or call option, the entity's initial transfer of the asset subject to the forward or call option is not considered a sale for accounting purposes because control of the asset is not considered to have transferred to the customer. Instead, the accounting for the contract depends on whether the repurchase price is less than the original selling price (after taking into consideration the time value of money). If so, it is accounted for as a lease, or if it is part of a sale-leaseback transaction, as a financing arrangement. If not (i.e., the repurchase price is equal to or more than the original selling price), it is accounted for as a financing arrangement.

If a forward or call option expires unused, the entity derecognizes any existing liability related to the forward or call option and recognizes revenue at that point in time.

The general premise behind the guidance on precluding an entity from recognizing revenue from contracts including a forward or call option is that control of the asset has not transferred to the entity's customer due to the customer being limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The Board recognized in paragraph BC425 of ASU 2014-09 that an entity may be able to overcome that general premise if the asset the entity sells to a customer that is either required to be repurchased or may be repurchased by the entity is a commodity (and as such, there are assets readily available in the marketplace that are substantially the same as the asset). If that is the case, and the repurchase price in the contract is the prevailing market price on the date of repurchase, the selling entity may be able to conclude that control of the commodity has transferred to the customer and recognize revenue in accordance with ASC 606. However, the Board also noted it would be unlikely for these transactions to be pervasive, given their nature. That is, in these situations, if an entity could overcome the general premise of the guidance, there is likely a lack of substance behind the forward or call option.

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9Q.7.1.1 Do call options to repurchase assets have to be evaluated to determine whether they are substantive?

Yes. The FASB stated in paragraph BC427 of ASU 2014-09 that: "…if the call option is nonsubstantive, that option should be ignored in assessing whether and when the customer obtains control of a good or service (to be consistent with the general requirement for any nonsubstantive term in a contract)."



Example 9-15: Determining the accounting model to apply to a call option and applying that model (ASC 606-10-55-401 to 55-404)

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

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.

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.

On January 1, 20X[8], the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.



RSM COMMENTARY: If the entity exercised the option on December 31, 20X7, it would derecognize the liability and reduce cash by $1.1 million.

If the entity could repurchase the asset for $900,000, and the $100,000 difference between the repurchase price and the original selling price ($1 million) is not just attributable to the time value of money, the entity would account for the contract as if it were the lessor in a lease. However, if this contract also included a leaseback to the entity (such that it was a sale-leaseback), the entity would account for it as a financing arrangement.

9.7.1.1 Contingently exercisable call options

ASC 606 does not specifically address how to account for call options that are contingently exercisable based on some future event. The inclusion of a non-contingent call option held by the entity in a contract with a customer generally limits the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. This precludes an entity from concluding that control has transferred to the customer and, therefore, the entity will not be able to recognize revenue from the sale of the asset. Since there is no specific guidance on contingently exercisable call options, we believe an entity should analogize to the guidance on non-contingent call options and consider whether the substance of the contingent call option precludes an entity from concluding that control has transferred to the customer. In performing this analysis, an entity should consider factors such as:

- *Who controls the event or condition that will resolve the contingency*: If the event is controlled by the entity, this would generally indicate that control has not transferred to the customer (and would be accounted for consistently with non-contingent call options). Alternatively, if the event is controlled by the customer, this may not preclude an entity from concluding that control has transferred.

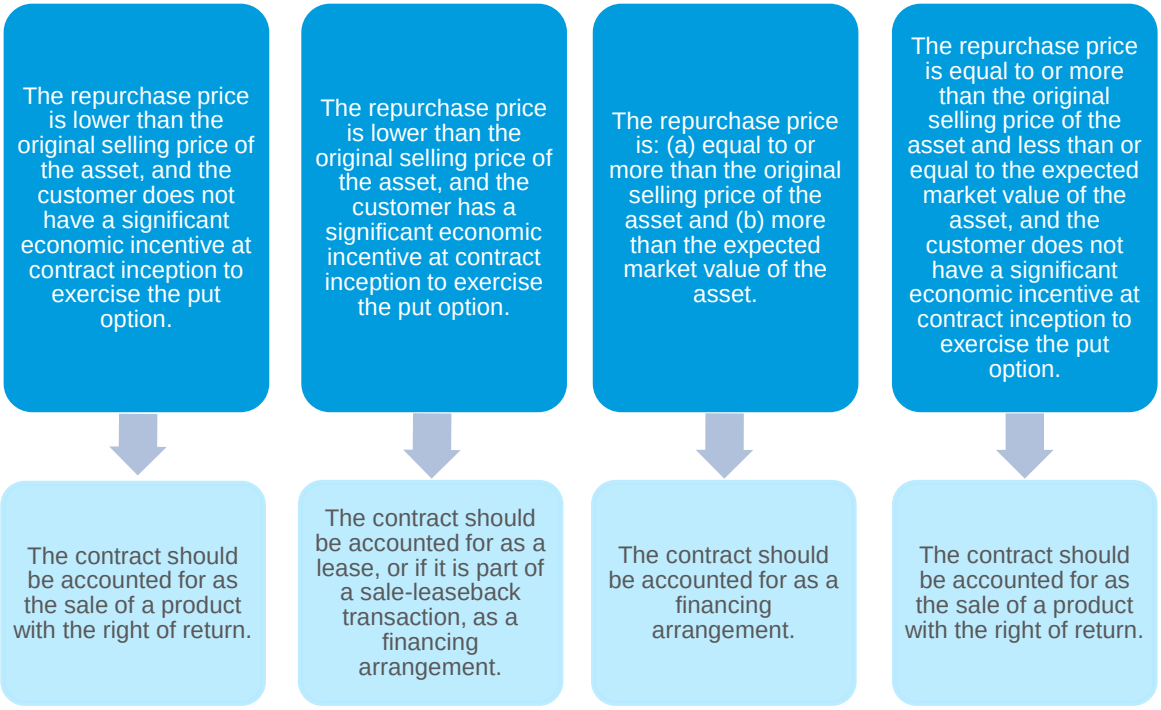
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- *The nature of the event or condition that resolves the contingency*: For example, if the contingency is only resolved once substantially all the benefits from the assets have been obtained by the customer, this may not preclude an entity from concluding that control has transferred to the customer.
- *The likelihood that the event or condition that resolves the contingency will occur*: If the likelihood of the event occurring is remote, this may not preclude an entity from concluding that control has transferred to the customer.

The relevance of the above factors may vary depending on the contingency. For example, if the event or condition that will resolve the contingency is not controlled by the entity or the customer, the entity may need to look more closely at the nature of the contingency and the likelihood that the event or conditions that resolves the contingency will occur to conclude whether control has transferred to the customer.

9.7.2 Accounting model for put options

For a put option, the entity's accounting requires consideration of whether the repurchase price of the asset is more or less than its original selling price, whether the repurchase price is more than the expected market value of the asset and whether the customer has a significant economic incentive to exercise the put option. As noted in the graphic that follows, depending on the facts and circumstances, these considerations may result in accounting for the put option as a financing arrangement (see Section 9.7.3), a lease or the sale of an asset subject to a right of return (see Section 7.3.6).



The comparison of the repurchase price and original selling price should be done after taking into consideration the time value of money. In addition, for purposes of determining whether a customer has a significant economic incentive to exercise a put option, the entity should consider all relevant facts and circumstances, including (but not limited to):

- *The relationship between the repurchase price and the expected market value of the asset.* If the repurchase price is significantly more than the expected market value of the asset, the customer may have a significant economic incentive to exercise the put option. Conversely, if the repurchase price is

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significantly less than the expected market value of the asset, the customer may not have a significant economic incentive to exercise the put option.

- *The length of time the put option is exercisable.* The longer the exercise period the more likely there is a significant economic incentive to exercise the put option.

If a put option expires unused, the entity derecognizes any existing liability related to the put option and recognizes revenue at that point in time.

Given the significantly different accounting models that could be applied to a put option depending on the facts and circumstances, an entity should ensure it has identified all the relevant facts and circumstances and that it has appropriately considered those facts and circumstances in determining the appropriate accounting model to apply to a put option.



Example 9-16: Determining the accounting model to apply to a put option and applying that model (ASC 606-10-55-401 and 55-405 to 55-407)

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

…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.

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.

In accordance with paragraphs 606-10-55-72 through 55-73, the entity accounts for the transaction as a lease in accordance with Topic 842 on leases.



RSM COMMENTARY: If this contract also included a leaseback to the entity (such that it was a sale-leaseback), the entity would account for it as a financing arrangement.

9.7.3 Financing arrangement accounting model

If the forward, call option or put option should be accounted for as a financing arrangement, at contract inception the entity: (a) continues to recognize the asset and (b) recognizes a financial liability for any consideration received from the customer.

Over the term of the forward, call option or put option, the entity should recognize interest and processing or holding costs (as applicable) for the difference between the consideration received from the customer and the consideration to be paid to the customer (see Example 9-15).

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Spotlight on change

Under legacy GAAP, when an entity sold equipment subject to a guaranteed minimum resale value, the entity accounted for the transaction as a lease. Under ASC 606, the accounting for these arrangements could change significantly depending on the facts and circumstances. If the terms of the arrangement could result in the entity reacquiring the equipment, it would be accounted for as a repurchase agreement, which could, depending on the facts and circumstances, lead to accounting for the arrangement as a lease, financing arrangement or sale subject to the right of return. If the arrangement only required the entity to make its customer whole for the difference between the customer's sale proceeds and the guaranteed minimum resale value, the arrangement would consist of two performance obligations under ASC 606 that would be accounted for separately: (1) the sale of equipment, which would be accounted for under ASC 606 and (2) a guarantee, which would be accounted for under ASC 460. Based on this discussion, the potential exists for the accounting for certain repurchase agreements to significantly change under ASC 606 compared to legacy GAAP.

9.8 Consignment arrangements and sales to distributors

When an entity ships products to a third party (e.g., a dealer or distributor) and that third party sells the products to consumers, the entity needs to consider whether the third-party seller obtains control over the products received from the entity prior to selling them to the consumer. In some cases, inventory shipped to third-party sellers is held on consignment, which means the third-party seller has not obtained control of the products received. Indicators that the third-party seller is holding the inventory on consignment include the following: (a) the entity retains control over the inventory until it is sold through to the consumer or until another specific point in time, (b) the third-party seller is not obligated to pay for the products until they are sold through to the consumer or (c) the entity can redirect the products to itself (i.e., require the third-party seller to return the products to the entity) or other parties (e.g., a different third-party seller).

When products shipped to a third-party seller are considered to be held on consignment, a performance obligation has not been satisfied (and no revenue is recognized), despite the fact that the products have been delivered to the third-party seller.

When products shipped to a third-party seller are not held on consignment, the performance obligation is satisfied when control of the products has transferred to the third-party seller. It would be inappropriate for the entity to delay recognizing revenue (e.g., until the third-party seller sells the products to consumers) when control of the products has transferred to the third-party seller. Consider the following example.



Example 9-17: Determining whether a consignment sale exists when product is sold to a third-party distributor

Company A manufactures snowmobiles and sells them to distributors. Customer B, a third-party distributor, purchases 20 snowmobiles. Upon receiving the snowmobiles, Customer B takes title, is responsible for all physical risks of loss (e.g., theft, fire) and is obligated to pay Company A $8,750 per month for 24 months (for a total of $210,000). Customer B has the right to return any snowmobiles not sold within two years. Company A cannot compel Customer B to return any of the snowmobiles or to transfer the snowmobiles to a different third-party distributor or any other party. Company A appropriately concludes that its contract with Customer B meets the contract existence criteria.

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Company A evaluates whether its sale to Customer B is a consignment sale as follows:

- *Does Company A retain control over the snowmobiles until they are sold through to the consumer or until another specific point in time?* To answer this question, Company A considers the relevant indicators of control transfer in Section 9.1:
  - Customer B is presently obligated to pay Company A $210,000 in 24 monthly installments of $8,750.
  - Customer B has legal title to the snowmobiles upon receiving them and until they are sold through to the consumer or returned to Company A within the return period.
  - Customer B has physical possession of the snowmobiles until they are sold through to the consumer or returned to Company A within the return period.
  - Customer B is responsible for all physical risks of loss until the snowmobiles are sold through to the consumer or returned to Company A within the return period. Customer B is somewhat protected against risk of economic loss, because if it does not sell the snowmobiles in two years, it has the right to return them to Company A. That said, Customer B has significant rewards related to controlling the snowmobiles until they are sold through to the consumer given the margin it earns on those sales.

  Based on this analysis, Company A concludes that it does not retain control of the snowmobiles. Instead, Customer B controls the snowmobiles until they are sold through to the consumer or returned to Company A within the return period, because Customer B has the ability to direct the use of the snowmobiles and receive substantially all of the related remaining benefits. While extended payment terms and the right of return do not affect whether control has transferred to the customer, such terms may affect the transaction price (i.e., the amount recognized as revenue).
- *Is Customer B not obligated to pay for the snowmobiles until they are sold through to the consumer?* No. Customer B is presently obligated to pay Company A $210,000 in 24 monthly installments of $8,750.
- *Can Company A redirect the snowmobiles to itself or other parties?* No. Company A cannot compel Customer B to return any of the snowmobiles or to transfer the snowmobiles to a different third-party distributor or any other party.

Based on its evaluation, Company A concludes that its sale to Customer B is not a consignment sale. As a result, Company A recognizes revenue when control of the snowmobiles transfers to Customer B. Both Customer B's right of return (see Section 7.3.6) and extended payment terms (see Section 7.4) are taken into consideration in determining the transaction price (the amount of revenue recognized by Company A when control of the snowmobiles transfers to Customer B).



Spotlight on change

While the implementation guidance that explains how to account for consignment arrangements in the context of ASC 606 is largely consistent with legacy GAAP, how to account for sales involving a distributor that are not consignment sales could change depending on the facts and circumstances.

Under legacy GAAP, revenue from sales involving a distributor (other than consignment sales) may have been recognized by a manufacturer of products on a sell-through basis, which resulted in revenue being deferred until the product is sold to the end user (rather than being recognized when delivered to the distributor). This is because arrangements with a distributor may include provisions for extended payment terms or significant product return rights, which

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draw into question whether the fee is fixed or determinable and whether the risks and rewards of ownership had transferred to the distributor, two key attributes of the general revenue recognition model in legacy GAAP. As a result, revenue from sales to these distributors may be recognized sooner under ASC 606 given that it requires revenue to be recognized upon transferring control of the product to the customer, which may be before the product is sold through to the end customer, which is when revenue is recognized on a sell-through basis under legacy GAAP.

9.9 Bill-and-hold arrangements

A bill-and-hold arrangement refers to a contract in which the customer purchases products and is billed for the products, but the entity retains physical possession of the products for a period of time. The key question in a bill-and-hold arrangement is whether control of the goods has transferred to the customer, despite the fact the goods are not in the customer's physical possession. Given the difficulty in answering this question, ASC 606 requires an entity to evaluate whether control has transferred to the customer using: (a) the general concept of control and indicators of control transfer (other than physical possession) (see Section 9.1) and (b) the following criteria specifically related to bill-and-hold arrangements, all of which must be met:

- *There is a substantive reason for the bill-and-hold arrangement.* An example of a substantive reason is the customer requesting to purchase the product on a bill-and-hold basis.
- *The products are separately identified as belonging to the customer.* This would be the case if the entity has segregated the products and labeled them as belonging to the customer.
- *The products are ready to be physically transferred to the customer.* This would be the case if the products are complete and ready for shipment. Further, to meet this criterion there should be no other costs to be incurred to satisfy the performance obligation other than standard shipping costs that would be incurred in other than bill-and-hold arrangements.
- *The entity is unable to use the products or redirect them to other customers.* To meet this criterion, the entity should not be able to use the specific products set aside for the customer in the bill-and-hold arrangement to fulfill orders from other customers. Further, if the entity has ever used or redirected product in the past that was set aside for a customer in connection with a bill-and-hold arrangement, its ability to meet this criterion and recognize revenue prior to shipment of the product in future bill-and-hold arrangements is tainted.

Revenue is recognized in a bill-and-hold arrangement prior to the customer taking physical possession of the product only if: (a) the entity's evaluation of the general concept of control transfer and the general indicators of control transfer results in a conclusion that control of the product has transferred to the customer and (b) the specific bill-and-hold criteria have been met.

If an entity concludes control of the products subject to a bill-and-hold arrangement has transferred to the customer prior to shipment, consideration should be given to whether the entity's obligation to hold the products for a period of time after it transferred control to the customer represents a performance obligation that should be accounted for separately.



Example 9-18: Accounting for a bill-and-hold arrangement (ASC 606-10-55-409 to 55-413)

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.

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

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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.

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.

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.

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.



RSM COMMENTARY: The specific bill-and-hold criteria in ASC 606-10-55-83 are met with respect to the spare parts performance obligation as follows:

- There is a substantive reason for the bill-and-hold arrangement as the customer requested to purchase the spare parts on a bill-and-hold basis.
- The products are separately identified as belonging to the customer as the spare parts are stored in a separate section of the entity's warehouse.
- The products are ready to be physically transferred to the customer as the spare parts can be immediately shipped to the customer upon its request.
- The entity is unable to use the products or redirect them to other customers.

Because all of the criteria in ASC 606-10-55-83 are met and because there are other indicators that control of the spare parts has transferred to the customer (i.e., the entity has received payment, the customer has legal title and customer acceptance has been obtained), the entity concludes revenue for the spare parts should be recognized before the customer takes physical possession of the spare parts (i.e., the point in time control of the spare parts transferred to the customer). As explained in the example, reaching that conclusion introduces another performance obligation related to providing custodial services related to the spare parts that continue to be held by the entity.

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Example 9-19: Determining whether an arrangement to deliver goods on a fixed date meets the bill-and-hold criteria when configuration services are also provided

Company A is in the business of procuring and configuring laptop computers for large organizations such as universities and corporations. The company has determined that its contracts with customers primarily include two separate performance obligations: delivery of laptops and specialized configuration services. Due to the unique nature and large quantity of laptops needed by customers, delivery of the laptops commonly takes approximately four to six weeks to complete. Company A has a fiscal year end of June 30, 20X1.

Company A enters into a contract with University B for the delivery of specialized laptops for all faculty to use in the upcoming academic year. Due to the anticipated lead time required to obtain and deliver the laptops, the contract was entered into on June 1, 20X1 to ensure that the laptops will be available for faculty when they return to campus at the end of July. In accordance with the terms of the agreement, standard configuration of the laptops will be performed prior to shipping and the laptops will be shipped immediately once those configuration services are complete. Specialized, unique configuration services will be performed by Company A remotely in the last week of July 20X1 when the faculty return and can access the University network with their new laptops.

Company A is able to obtain the laptops at the lower end of their anticipated lead time and performs the standard configuration services so that the laptops are boxed, palleted and ready to ship by June 25, 20X1. Company A informs the university that the laptops will be delivered by June 30, 20X1 and invoices University B for the performance obligation for the laptops. University B contacts their sales representative at Company A and requests that shipment be delayed since the university operates with minimal operational resources during the early summer and is unable to handle the receipt and storage of the large order. Due to this, Company A and University B sign an updated agreement prior to June 30, 20X1 specifying the following:

- Company A will segregate the laptops, identified in the contract with serial numbers, from their other inventory so that they are identified as belonging to the University, and will ensure the products are complete and ready for shipment on July 15.
- Company A is prohibited from using the specified laptops to satisfy orders from different customers and will hold the laptops to satisfy University B’s order.
- Title to the laptops will transfer to the university at the date of the signed agreement. Upon transfer of title, University B shall bear the risk of obsolescence, including the risk of any fluctuation in value, and the risk of loss will transfer to it.
- University B is obligated to pay for the invoices from Company A for the laptops in accordance with regular payment terms regardless of when shipment occurs.

On July 15, 20X1, the laptops ship. Subsequently, Company A employees remotely complete the final configuration services specific to the faculty users of the laptops.

Based on the updated agreement, Company A assesses the bill-and-hold criteria in ASC 606-10-55-83 with respect to the laptop performance obligation as follows:

- There is a substantive reason for the bill-and-hold arrangement, as the customer requested to purchase the laptops on a bill-and-hold basis due to not having enough operational resources to receive them when completed.
- The laptops are separately identified as belonging to the customer, as the laptop serial numbers were listed in the contract and stored separately from other inventory.

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- The laptops are ready to be physically transferred to the customer, as the configuration services required before shipment have been performed and the laptops have been boxed and palleted for shipment.
- The entity is unable to use the specified laptops to fulfill other customer orders.

Because all the criteria in ASC 606-10-55-83 are met, and because there are other indicators that evidence that control of the laptops have been transferred to the customer (i.e., University B is presently obligated to pay Company A, has legal title to the laptops, and has the significant risks and rewards of ownership of the laptops), the entity concludes revenue for the laptops should be recognized before the University takes physical possession of the laptops, which, as noted above, was prior to June 30, 20X1. Regarding the separate performance obligation for specialized configuration services, Company A would not recognize revenue until the services are performed on July 15, 20X1 (i.e., the next fiscal year). Company A should also consider whether its obligation to store the laptops for the period of time after it transferred control to the customer represents a separate performance obligation.



Example 9-20: Determining whether an arrangement to deliver goods on an as-requested basis meets the bill-and-hold criteria when configuration services are also provided

Company A is in the business of procuring and configuring laptop computers for large organizations such as universities and corporations. The company has determined that its contracts with customers primarily include two separate performance obligations: delivery of laptops and specialized configuration services. Due the unique nature and large quantity of laptops needed by customers, delivery of the laptops commonly takes approximately four to six weeks to complete. Company A has a fiscal year end of June 30, 20X1.

The company enters into a contract with Customer B on June 1, 20X1 for the delivery of a large quantity of specialized laptops for the customer's new and existing employees. In accordance with the terms of the agreement, standard configuration of the laptops will be performed once Company A receives them. Over the next year, as Customer B identifies employees in need of technology upgrades, Customer B can request for Company A to perform specialized configuration services unique to the identified employee and immediately ship the uniquely configured laptop to the employee's location. Company B requested that Company A store the equipment because it does not normally handle IT equipment, and it does not have appropriate inventory space to store a large number of laptops. The signed agreement also stipulates the following:

- Company A will segregate the laptops from its other inventory so that they are identified as belonging to Customer B.
- Customer B is obligated to pay for the invoices from Company A for the laptops held by Company A in accordance with regular payment terms regardless of when shipment occurs.

On June 15, 20X1, Company A obtains the laptops for Customer B and installs all standard software on them. Additionally, on that date, Company A bills Customer B for the laptops. At that time, Customer B had not yet requested any laptops for its employees; therefore, Company A could not complete the specialized configuration services.

Starting in July 20X1, Customer B informs Company A that it has specific employees that require upgraded laptops and requests that Company A begin configuring the laptops for those employees and shipping them to Customer B. Company A performs the specialized configuration services and immediately ships the fully configured laptops to Customer B.

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Based on the signed agreement, Company A assesses the bill-and-hold criteria in ASC 606-10-55-83 with respect to the laptop procurement performance obligation as follows:

- There is a substantive reason for the bill-and-hold arrangement, as the customer requested Company A to store the laptops until Customer B notifies Customer A that an employee requires a laptop to be configured and shipped.
- Company A is required to segregate the laptops from other inventory in accordance with the agreement, but the laptops are not specifically identifiable in the contract.
- The laptops are not ready to be physically transferred to the customer, as the specialized configuration services required before shipment have not yet been performed.
- The entity has the ability to redirect laptops to other customers without Customer B's knowledge because the laptops were never specifically identified in the contract.

Because all of the criteria in ASC 606-10-55-83 are not met (i.e., the laptops are not ready to be physically transferred and they had the ability to be redirected to other customers), revenue related to the laptop performance obligation cannot be recognized until shipments of the laptops begin in July 20X1. The recognition of revenue upon shipment assumes that control of the laptops has also transferred to Customer B.



Spotlight on change

With certain exceptions, the criteria in ASC 606 that must be met to recognize revenue for a bill-and-hold arrangement prior to the customer taking physical possession of the products are similar to the criteria included in legacy GAAP. One exception arises because legacy GAAP included (while ASC 606 does not include) a criterion that required there to be a fixed schedule for delivery of the goods that is reasonable and consistent with the customer's business purpose. As a result, if a bill-and-hold transaction failed only this criterion under legacy GAAP, revenue for that transaction likely would be recognized earlier under ASC 606 (i.e., before the customer takes physical possession of the product). However, while ASC 606 does not explicitly state a fixed delivery schedule as a required bill-and-hold criterion, the absence of such could indicate that all contract existence criteria in ASC 606 are not met (See Section 5.2) and control has not transferred. In particular, the first contract existence criterion that both parties are committed to perform under the arrangement may not be met if the entity does not understand how long it will be expected to store the products and is not adequately compensated for both the products and related storage performance obligation.

Example 9-18 illustrates a situation in which there is not a fixed schedule for delivery of spare parts, only an indication that the entity expects to hold the spare parts for two to four years. As a result, the entity would not have recognized revenue for the spare parts on a bill-and-hold basis under legacy GAAP, which would delay the timing of recognizing revenue for the spare parts compared to ASC 606.

Another exception between the bill-and-hold criteria in legacy GAAP and ASC 606 arises because legacy GAAP requires the customer to have requested the arrangement take place on a bill-and-hold basis, while ASC 606 uses the customer requesting that the arrangement take place on a bill-and-hold basis as an example of a substantive reason for the bill-and-hold arrangement. In other words, ASC 606 does not require the customer to have requested the arrangement take place on a bill-and-hold basis. These exceptions could result in an arrangement that failed the bill-and-hold criteria under legacy GAAP meeting the bill-and-hold

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criteria in ASC 606, and as a result, the entity recognizing revenue sooner under ASC 606 than under legacy GAAP.

9Q.9.1 When should revenue be recognized for sales of certain vaccines placed into a Federal Government stockpile program?

Federal Government vaccine stockpile programs are unique in various ways, including that the main objective of these programs is not to take delivery of the vaccine for use. Rather, the objective of the programs is to be able to require immediate delivery in the future once the vaccine manufacturer is notified. The SEC issued an interpretive release in 2017 addressing the specific revenue recognition treatment for certain vaccines placed into Federal Government stockpile programs, which noted that revenue should be recognized when these vaccines are placed into the stockpile program. This guidance applies to childhood disease vaccines, influenza vaccines and other vaccines and countermeasures sold to the Federal Government by vaccine manufacturers for placement in the Strategic National Stockpile and should not be applied to other transactions.

9.10 Customer acceptance

Customer acceptance provisions require acceptance by a customer that the good or service provided by the entity meets agreed-upon specifications. The question that arises when customer acceptance provisions are included in a contract is whether acceptance must be obtained from the customer before the entity is able to conclude that control of the good or service has transferred to the customer.

If the entity can objectively determine that the goods or services meet the agreed-upon specifications (e.g., specified size and weight characteristics) before the customer accepts the goods or services, acceptance by the customer is not necessary to conclude that control has transferred to the customer. Conversely, the inability to objectively determine whether the goods or services meet the agreed-upon specifications before the customer accepts the goods or services makes it necessary for the entity to obtain customer acceptance before it concludes control has transferred to the customer. As a result, if customer acceptance is based on subjective criteria (e.g., customer satisfaction), then the entity cannot conclude that control has transferred to the customer until the customer provides acceptance.

Whether the entity can objectively determine that the goods or services meet the agreed-upon specifications before receiving customer acceptance depends on the facts and circumstances. The entity should consider its history in similar situations. In addition, the entity should consider the nature and extent of any quality control procedures performed to ensure the customer acceptance provisions are met prior to transferring the product (or other product subject to the same manufacturing process) to the customer.

If the entity concludes that it is appropriate to recognize revenue before the customer accepts the goods or services included in a performance obligation, it should only recognize revenue for that performance obligation and not for related performance obligations. For example, consider a situation in which an entity enters into a contract to sell the customer equipment and installation services and the equipment is subject to customer acceptance provisions. If the equipment and installation services are each a performance obligation and the entity concludes it should recognize revenue for the equipment performance obligation before the customer accepts the equipment, the entity should only recognize revenue for that performance obligation (and not also the performance obligation for the installation services).

The implementation guidance that explains how to account for customer acceptance provisions in the context of ASC 606 is largely consistent with legacy GAAP.

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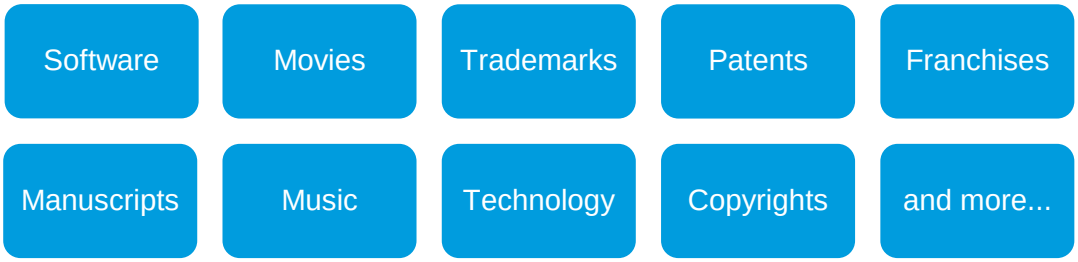
9.10.1 Products provided to the customer for trial or evaluation purposes

If the contract requires the entity to provide products to the customer for trial or evaluation purposes, consideration must be given to when the customer is obligated to pay. If the customer is not obligated to pay until the trial period lapses, control of the products does not transfer to the customer until the trial period lapses or the customer accepts the products.

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10. Licensing and rights to use

Licensing involves an entity (i.e., licensor) providing a customer (i.e., licensee) with a right to use its IP, which may come in many different shapes and sizes. Examples of IP that may be the subject of a license include:



It is important to note that the entity still owns the IP subject to the license (i.e., ownership of the IP does not transfer to the customer). Depending on the facts and circumstances, ASC 610-20 may apply to outright sales of IP to parties other than customers (see Appendix A and Example A-5).

The same five steps are applied to a contract that includes a license of IP as are applied to other contracts. However, given the unique nature of IP, additional implementation guidance was provided in ASC 606 with respect to applying the following steps to contracts that include a license of IP:

- Identifying the performance obligations in the contract (Step 2)
- Determining the transaction price (Step 3)
- Recognizing revenue when (or as) each performance obligation is satisfied (Step 5)

The implementation guidance related to Steps 2 and 5 is discussed in the remainder of this chapter. The implementation guidance related to Step 3 addresses the recognition of sales and (or) usage-based royalties related to a license of IP, including the treatment of a minimum guarantee, which is discussed in Section 7.3.5.

Spotlight on change

While there were some industry-specific revenue recognition models in legacy GAAP that provided guidance on how to account for licenses and rights to use specific types of IP (e.g., software, motion pictures, franchises), these models were very different from the model in ASC 606. In addition, ASC 606 fills a deep void for licenses and rights to use other types of IP not specifically covered in legacy GAAP. For these reasons, the accounting for licenses and rights to use IP changed significantly under ASC 606.

10.1 Identifying the performance obligations in a contract that includes a license of IP

In some situations, a contract may only include a license of IP. In other situations, a contract may include one or more licenses of IP in addition to other promised goods or services (e.g., a software license and installation services). As discussed in Section 6.1, these other promised goods or services may be explicit (i.e., stated in the contract) or implicit (e.g., resulting from the entity's customary business practices).

When a contract includes a license of IP and other promised goods or services, the entity must consider whether the license of IP is distinct from the other promised goods or services (see Section 6.2). If a license of IP is distinct (and none of the other licenses or promised goods or services need to be bundled with it because they are not distinct), it is a performance obligation. If the license of IP is not distinct, it is combined with other licenses of IP and (or) promised goods or services in the contract until a distinct

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group of promised goods or services (and, therefore, a performance obligation) exists. Examples of licenses of IP that are not distinct from other promised goods or services in the contract include the following:

- A license of IP included with the sale of a tangible good, and the license of IP is an integral component to the functionality of the good (e.g., an automobile with embedded software)
- A license of IP included with the sale of a service, and the customer does not benefit from the license of IP absent the service (e.g., a SaaS arrangement) (see Question 10Q.1.2)

Consider the following examples.



Example 10-1: Determining whether a software license and when-and-if-available update rights are distinct (ASC 606-10-55-140D to 55-140F)

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.

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.

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.



RSM COMMENTARY: One of the key facts leading to the conclusion that the software and when-and-if-available update rights are not distinct from each other is how critical the updates are to the continued utility of the software. Most when-and-if-available software updates will not be so critical to the continued utility of the software that the software and updates are deemed not to be distinct from each other. Example 10-2 illustrates the more common scenario in which software and when-and-if-available software updates are deemed to be distinct from each other.

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Example 10-17 illustrates how to determine whether: (a) a performance obligation that includes a license of IP and when-and-if-available updates to that IP is satisfied over time or at a point in time and (b) if the performance obligation is satisfied over time, the method that should be used to measure the progress toward complete satisfaction of the performance obligation.



Example 10-2: Identifying the performance obligations in a contract for a software license, unspecified software updates, installation services and technical support (ASC 606-10-55-141 to 55-150)

Case A—Distinct Goods or Services

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.

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.

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.

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.

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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

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.

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.

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.

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RSM COMMENTARY: Example 10 (Case C) referenced in this example is included in Example 10-1 within this guide.

While most software licenses and when-and-if-available software updates will be distinct from each other (as illustrated in this example), there are situations (such as the one illustrated in Example 10-1) in which the software license and a when-and-if-available software update are not distinct from each other because the update is critical to the continued utility of the software.

In both Case A and Case B of Example 10-2, the installation services could be provided by another party. While that fact resulted in the installation services being considered capable of being distinct in both cases, whether a promised good or service is capable of being distinct is only one of the criteria that must be met under ASC 606 to conclude that the promised good or service is distinct. The other criterion is focused on whether the promised good or service is distinct within the context of the contract. An evaluation of this criterion in Case A and Case B resulted in different conclusions given the nature of the installation services provided in each case:

Nature of the installation services	
Case A	**Case B**
• Changing the web screen for each type of user (e.g., marketing, inventory management, IT) • Routine • No significant modifications to the software	• Substantial customization to add significant new functionality to enable the software to interface with certain of the customer's other customized software applications

Given the nature of the installation services in each case:

- While installation services are inherently an integration service, the level of integration between the software and installation services is not significant in Case A, while it is significant in Case B.
- While the software and installation services are inherently interdependent or interrelated, it is likely there is not a high degree of interdependence or interrelationship in Case A (because the installation services are routine and do not significantly modify the software), while it is likely there is a high degree of interdependence or interrelationship in Case B (because the installation services are what converts the software into the functional and integrated software system the customer expects to receive).
- The installation services in Case A do not significantly modify and customize the software, while they do in Case B.

For these reasons, the entity concluded that the installation services in Case A are distinct within the context of the contract, while the entity concluded in Case B that the installation services are not distinct within the context of the contract.

Example 10-8 illustrates how to determine whether a performance obligation for a software license is satisfied over time or at a point in time when there is also a performance obligation for when-and-if-available software updates (which is similar to part of Case A in this example).

Example 10-15 illustrates how to determine: (a) whether a performance obligation that includes a software license and installation services is satisfied over time or at a point in time and (b) if

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the performance obligation is satisfied over time, the method that should be used to measure the progress toward complete satisfaction of the performance obligation (which is similar to part of Case B in this example).



Example 10-3: Determining whether a license for a drug compound and specialized manufacturing services are distinct (ASC 606-10-55-367 to 55-370)

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.

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.

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.



RSM COMMENTARY: Additional facts would be needed to determine whether the performance obligation in this example is satisfied over time or at a point in time. However, if the additional facts indicated that the performance obligation is satisfied over time, revenue would be recognized over the five-year period during which the manufacturing services are transferred to the customer. The period over which revenue would be recognized would be limited to five years (and would not be the full ten-year license period) because the license of the drug compound provides the customer with the right to use IP with significant standalone functionality, and once the entity transfers control of the drug compound to the customer, its responsibilities with respect to that license are satisfied (see Section 10.2.1). As a result, once the entity finishes transferring the manufacturing services at the end of five years, its responsibilities with respect to both the license and the manufacturing services are satisfied (which is illustrated in Example 10-9). Additional facts would be needed to determine the method by which to measure the progress toward complete satisfaction of the performance obligation over the five-year period the manufacturing services are provided.

While there was no expectation that the entity would undertake activities to change the drug compound in this example, if there was such an expectation, the entity would determine

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whether the customer had rights to those changes (if any) through, for example, having rights to when-and-if available updates to the drug compound. If the customer had such rights, they would have represented an additional promised good or service that the entity would have had to evaluate to determine whether it was distinct from the license of the drug compound.

Example 10-4 illustrates a situation in which the license for the drug compound and the manufacturing services are distinct, and therefore, are accounted for separately as performance obligations.



Example 10-4: Determining whether a license for a drug compound and routine manufacturing services are distinct (ASC 606-10-55-367 and 55-371 to 55-372A)

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.

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.

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RSM COMMENTARY: Whether the performance obligation for the license of the drug compound is satisfied over time or at a point in time is addressed in Example 10-9.



Example 10-5: Determining whether franchise rights and equipment are distinct (ASC 606-10-55-375 to 55-377)

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.



RSM COMMENTARY: Whether the performance obligation for the franchise rights is satisfied over time or at a point in time is addressed in Example 10-12.

Example 10-16 illustrates how to measure progress toward the complete satisfaction of a performance obligation that: (a) includes both franchise rights and consulting services (because they were not distinct from each other) and (b) is satisfied over time.

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Example 10-6: Determining whether two licenses for television episodes are distinct from each other (ASC 606-10-55-399A and 55-399F to 55-399J)

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.

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.

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).



RSM COMMENTARY: Case B in Example 10-14 addresses whether each performance obligation in this example is satisfied at a point in time or over time.

Case A in Example 10-14 addresses a situation in which the customer only obtains a license to the first four seasons of the television episodes but is aware that: (a) Season 5 is in production and (b) the entity continues to promote the show.

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10Q.1.1 What effect do restrictions on the period of time, the geographical region, or the way in which the license of IP may be used have on the number of performance obligations identified in a contract?

To properly account for a license with restrictions, the entity must determine whether restrictions on time, geographical region or the way in which the licensed IP may be used represent:

- *Attributes of the license that define its scope*. If the restrictions represent attributes of the license that define its scope, they do not give rise to additional promised goods or services and do not affect whether the license of IP is a performance obligation that is satisfied over time or at a point in time.
- *Additional rights that will be transferred to the customer in the future*. If the restrictions represent additional rights that will be transferred to the customer in the future, those additional rights are promised goods or services that must be reflected in the identification of the performance obligations.

Making the determination as to whether a restriction of time, geographical region or use represents an attribute of the license that defines its scope or additional rights that will be transferred to the customer in the future will require exercising a significant amount of judgment and careful consideration of all the facts and circumstances. Consider the following example.



Example 10-7: Determining whether a restriction of time is an attribute of a single license or a second license (ASC 606-10-55-399K to 55-399O)

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.

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).

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.

The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the

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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.

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.



RSM COMMENTARY: This example includes two rights to use the same IP and illustrates that control of each right to use transfers to the customer no earlier than when each right to use begins. In other words, the customer controls each right to use the IP upon the date each right of use begins even though the customer may have access to the IP prior to that date.

Example 10-11 illustrates a situation in which restrictions in the time period, geographical scope and permitted use are attributes of a single license and not one or more additional licenses. In addition, Case A of Example 10-14 illustrates a situation in which a restriction on how the customer may use the license is an attribute of a single license and not an additional license.

10Q.1.2 Does a contract that includes hosted software include a software license for purposes of applying ASC 606?

A contract for hosted software includes a software license for purposes of applying ASC 606 if both of the following criteria are met:

- The contract allows the customer to take possession of the software as it is being hosted without incurring a significant penalty.
- If the customer were to take possession of the software during the hosting period, at least one of the following would be feasible: (a) running the software on its own hardware or (b) contracting with an unrelated third party to host the software.

For purposes of determining whether the customer can take possession of the software without significant penalty, consideration must be given to whether the customer can take possession without incurring significant cost and without experiencing a significant decline in the software's utility or value. If a contract for hosted software includes a software license, the license and hosting services are treated as promised goods or services for purposes of applying ASC 606. If a contract for hosted software does not include a

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software license for purposes of applying ASC 606, the hosting of the software (which is often referred to as a SaaS arrangement) is one promised service for purposes of applying ASC 606.

10Q.1.3 For "hybrid cloud" or "hybrid SaaS" arrangements, what should an entity consider when identifying performance obligations?

A hybrid cloud or hybrid SaaS arrangement provides a customer with both a license to on-premise software and access to SaaS or other cloud-based services (services). The functionality of these hybrid arrangements will vary depending on the software provider and the specific needs of the customer. For example, one arrangement may provide the customer with the ability to use a software application both online (cloud-based) and offline (stemming from an on-premise component) while another may allow a customer to use on-premise software in conjunction with cloud-based services.

When considering whether the on-premise software and the services included in the hybrid software arrangement should be one performance obligation or multiple performance obligations, an entity should assess the criteria for determining whether promises are distinct, as discussed in Section 6.2. When assessing those criteria, an entity will need to understand the standalone functionality of both the on-premise software and the services and how the functionality of each interacts with each other (i.e., is there constant or significant interaction between the two that may create additional functionality not available when only one software component is provided). However, given the nature of these arrangements, an entity will likely have to use judgment when assessing the two criteria.

In circumstances in which the license to on-premise software or services has insignificant standalone functionality, or the customer can only derive the intended benefit from the license in conjunction with the related services (or vice versa), the on-premise software and services will not be distinct (and there will be one performance obligation).

In circumstances in which both the on-premise software and the services have significant functionality when operated individually, the typical conclusion is that they are distinct and represent two performance obligations. However, an entity should still assess whether the functionality of the combined on-premise software and service is highly interdependent and highly interrelated (e.g., the functionality of each is significantly affected when combined and offer a greater output or benefit for the customer that is substantively different from the benefits derived from each individually). If so, the on-premise software and the service would not be distinct (resulting in one performance obligation). This is in contrast to situations in which the functionality of the combined on-premise software and SaaS or cloud-based services is only additive, meaning the benefits of the combination do not alter the functionality of the individual components. (e.g., the services enhance the processing speed of certain functions of the on-premise software or add the ability to perform analytics on the data housed in the on-premise software). In these situations, the on-premise software and the service would not be highly interdependent or highly interrelated and would be distinct (and result in two performance obligations).

Other factors, which are not exhaustive or individually determinative, that may be considered include whether the entity's on-premise software and service are ever sold individually and whether the customer can benefit from each product or service together with other resources readily available to the customer (e.g., if a competitor offered a similar cloud-based service that could be used in conjunction with the on-premise software from the vendor).

10Q.1.4 Are promises provided by the entity that it will defend the patent against unauthorized use promised goods or services?

No. Such promises are not promised goods or services.

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10.2 Determining whether a performance obligation that includes a license of IP is satisfied over time or at a point in time

The entity must determine whether the transaction price allocated to the performance obligation that includes a license should be recognized over time or at a point in time. The starting point for this determination differs depending on whether the performance obligation only includes a license of IP or a license of IP and other promised goods or services.

10Q.2.1 Should guarantees or promises provided by the entity that it has a valid patent to the IP or that it will defend the patent against unauthorized use affect when a performance obligation for the license of patented IP is satisfied?

No. Such guarantees and promises do not affect when the performance obligation is satisfied (i.e., whether revenue should be recognized over time or at a point in time).

10Q.2.2 Do restrictions on the period of time, the geographical region or the way in which the license of IP may be used affect whether a performance obligation for a license of IP is satisfied over time or at a point in time?

If the restrictions on the period of time, geographic region or way in which the license of IP may be used are considered attributes of the license that define its scope, they do not affect whether the license of IP is a performance obligation that is satisfied over time or at a point in time. Question 10Q.1.1 discusses the implications if the restrictions represent additional rights that will be transferred to the customer in the future.

10.2.1 Performance obligation only includes a license of IP

When the performance obligation only includes a license of IP, the key question in determining whether the related revenue should be recognized over time or at a point in time is whether the license of the IP represents: (a) a right to use the IP, in which case the allocated transaction price should be recognized at a point time, or (b) a right to access the IP over time (the shorter of the license period or the IP's remaining economic life), in which case the allocated transaction price should be recognized over time. Determining whether the license of IP represents a right to use the IP or a right to access the IP is based on whether the IP has significant standalone functionality.



In theory, a license of IP that has significant standalone functionality provides benefit and value to the customer as it exists at the point in time the license is granted, which is why such a license is considered satisfied at a point in time. Conversely, a license of IP that does not have significant standalone functionality only provides benefit and value to the customer as a result of the entity's past activities and ongoing activities to support and maintain the IP over the license period (or the remaining economic life of the IP, if shorter) by undertaking activities that preserve its utility (or not undertaking activities that will diminish its utility), which is why such a license is considered satisfied over time. The activities undertaken by the entity to support and maintain the IP are not promised goods or services and may just originate from the entity's ordinary activities.

To have significant standalone functionality, a substantial part of the IP's utility must come from its ability to provide benefit or value to the customer in and of itself (i.e., the entity does not need to undertake any

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additional activities over the license period for the IP to provide benefit and value to the customer). IP with significant standalone functionality includes IP that provides benefits or value to the customer because it is capable of processing a transaction, executing a function or task or being played or aired. When the IP has significant standalone functionality, the license of the IP is considered a right to use the IP unless both of the following criteria are met:

- Substantive changes to the functionality of the IP are expected to result during the license period from activities of the entity that do not transfer a promised good or service to the customer.
- The customer must use (either contractually or practically) the substantively changed IP.

If both of these criteria are met, what would otherwise be considered a right to use the IP would be considered a right to access the IP. The FASB indicated in paragraph BC58 of ASU 2016-10 that they would expect both of these criteria to be met "only infrequently."

When the IP does not have significant standalone functionality, it is considered symbolic IP. A license of symbolic IP is considered a right to access the IP.

When a license is considered a right to use the IP, the entity should consider the indicators for transfer of control (see Section 9.1) for purposes of determining whether control was transferred at the point in time the license was granted or at another point in time (such as when the license key is provided to the customer for a software license). When a license is considered a right to access the IP, the entity has to identify an appropriate method by which to measure its progress toward complete satisfaction of the right to access the IP (see Section 9.3). Regardless of whether a license is considered a right to use the IP or a right to access the IP, revenue related to a license of IP should not be recognized before both of the following occur:

- A copy of the IP has been provided or otherwise made available to the customer.
- The period over which the customer is able to use and benefit from its rights to the IP has started (i.e., the license period has begun).

The need to meet the second of these criteria before revenue is recognized results in revenue related to a license renewal being recognized no earlier than the beginning of the renewal period.



Example 10-8: Determining whether a performance obligation for a software license is satisfied over time or at a point in time when there is also a performance obligation for when-and-if-available software updates (ASC 606-10-55-141 to 55-145 and 606-10-55-362 to 55-363B)

This example is a continuation of Case A in Example 10-2:

Using the same facts as in Case A in Example 11 (see paragraphs 606-10-55-141 through 55-145) [included herein], [in which] 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.

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

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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.

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.

On the basis of this assessment, the entity identifies four performance obligations in a contract:

a. The software license

b. An installation service

c. Software updates

d. Technical support.

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 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.

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).

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.

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RSM COMMENTARY: Example 10-2 explains why the software license and when-and-if-available software updates are distinct from each other in this fact pattern. Example 10-1 illustrates another fact pattern in which the software license and when-and-if-available software updates are not distinct from each other.



Example 10-9: Determining whether a performance obligation for the license of a drug compound is satisfied over time or at a point in time when there is also a performance obligation for manufacturing services (ASC 606-10-55-373 to 55-374)

This example is a continuation of Example 10-4.

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.



RSM COMMENTARY: Case B of Example 10-4 explains why the license and manufacturing services are distinct in this fact pattern, and Example 10-4 also presents Case A in which the license and manufacturing services are not distinct.



Example 10-10: Determining whether a performance obligation for the license of comic strip characters is satisfied over time or at a point in time (ASC 606-10-55-383 to 55-388)

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.

In exchange for granting the license, the entity receives a fixed payment of $1 million in each year of the 4-year term.

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

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service to the customer. Therefore, the entity concludes that its only performance obligation is to transfer the license.

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.

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.

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 10-11: Determining whether a performance obligation for the license of a music recording is satisfied over time or at a point in time and how to account for a renewal of the license (ASC 606-10-55-389 to 55-392D)

Case A—Initial License

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.

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.

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.

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Therefore, the criteria in paragraph 606-10-55-62 are not met.

In accordance with paragraph 606-10-55-58B, the promised license, which provides the customer with a right to use the entity's intellectual property, is a performance obligation satisfied at a point in time. The entity recognizes revenue from the satisfaction of that performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Additionally, because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

Case B—Renewal of the License

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.

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.

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.

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.



RSM COMMENTARY: Case B of this example illustrates that revenue related to the renewal of a license cannot be recognized until the start of the renewal period regardless of whether the license is a right to use IP that is satisfied at a point in time or a right to access IP that is satisfied over time. ASC 606 essentially indicates that the customer cannot have control of the IP subject to a license renewal until the renewal period begins.

The guidance applicable to contract modifications, along with examples illustrating that guidance, is included in Section 5.5.

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Example 10-12: Determining whether a performance obligation for a franchise license is satisfied over time or at a point in time (ASC 606-10-55-380 to 55-382)

This example is a continuation of Example 10-5.

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.

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.



RSM COMMENTARY: Example 10-5 addresses identifying the performance obligations in this fact pattern. Example 8-7 addresses allocating the transaction price to the performance obligations in this fact pattern.



Example 10-13: Determining whether a performance obligation for the license of a sports team name and logo is satisfied over time or at a point in time (ASC 606-10-55-395 to 55-399)

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.

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

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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.

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).

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.

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.



Example 10-14: Determining whether a performance obligation for television show episodes is satisfied over time or at a point in time (ASC 606-10-55-399A to 55-399J)

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

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.

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

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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.

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

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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).

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.



RSM COMMENTARY: This example emphasizes that control of the licensed episodes does not transfer to the customer until the date the customer is first permitted to air the episodes.

10.2.2 Performance obligation includes a license of IP and one or more other promised goods or services

When the performance obligation includes a license of IP and one or more other promised goods or services (because they are not distinct from each other), the entity must determine whether the performance obligation is satisfied at a point in time or over time and, if it is the latter, what method it should use to measure progress toward the complete satisfaction of the performance obligation. In doing so, the entity should still take into consideration whether the license of IP provides the customer with a right to use the IP or a right to access the IP.

The FASB staff and TRG discussed identifying a method to measure progress toward complete satisfaction of a performance obligation that includes multiple promised goods or services (which could include a license of IP) that are not distinct. This issue was addressed in Questions 47 and 48 of the FASB RRI Q&As, and the FASB staff and TRG concluded that an entity must identify a single method by which to measure progress toward the complete satisfaction of a performance obligation even when the performance obligation includes a bundle of promised goods or services. In other words, an entity may not identify one method to apply to a license of IP and another method to apply to a service when the license and service are not distinct from each other. To do so likely would circumvent the reasons the license of IP and service were bundled together to form one performance obligation in the first place.

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In some cases, a performance obligation may include a license of IP and another promised good or service (which could be another license) that have the same pattern of transfer to the customer, which should make the selection of a method to measure progress toward the complete satisfaction of the performance obligation relatively straightforward. However, in other cases, the license of IP and other promised goods or services in the performance obligation may have different patterns of transfer to the customer. In these cases, identifying the method to measure progress toward complete satisfaction of the performance obligation may be more difficult. An entity should consider the following when identifying an appropriate method in these situations:

- The nature of what the license of IP and other promised goods or services come together to provide the customer.
- The reason(s) why the license of IP and other promised goods or services were combined into one performance obligation.
- Whether there are any activities that will be performed in conjunction with satisfying the performance obligation that are not themselves promised goods or services, and whether those activities have been ignored for purposes of identifying an appropriate method to measure progress toward the complete satisfaction of the performance obligation (see Section 6.1.4 and Example 9-9).

In addition, in situations in which an entity is finding it particularly difficult to identify a single method to measure progress toward complete satisfaction of a performance obligation that includes a license of IP and other promised goods or services, the FASB staff and TRG suggested that an entity reconsider whether it has identified the appropriate performance obligations in the contract. This does not mean it is a given that the entity has identified inappropriate performance obligations when it is finding it particularly difficult to identify a single method to measure its progress in satisfying a performance obligation that includes a license of IP and other promised goods or services. In other words, it may be inherently difficult to identify a single method of measuring progress toward the complete satisfaction of such a performance obligation.

Ultimately, the entity's goal is to identify a method to measure progress toward the complete satisfaction of a performance obligation that achieves the intended objective, which is to "depict an entity's performance in transferring control of goods or services promised to a customer." Identifying this method will require an entity to exercise significant judgment and carefully consider all its facts and circumstances.

10Q.2.2.1 When an entity has performance obligations that include a license of IP and other promised goods or services that are not distinct, may it adopt an accounting policy under which the measure of progress is based on transferring the license of IP if it is the predominant promised good or service in the contract?

No. When an entity has performance obligations that include a license and other promised goods or services that are not distinct, it should not have an accounting policy that will automatically result in the method used to measure progress toward the complete satisfaction of the performance obligation being based on transferring the license of IP just because it is the predominant promised good or service in the performance obligation. Each set of facts and circumstances involving a performance obligation that includes a license of IP and other promised goods or services should be carefully evaluated to determine the method that should be used to measure progress toward the complete satisfaction of that performance obligation. While doing so may result in the entity using a method to measure progress toward the complete satisfaction of the performance obligation that is based on transferring the license of IP because it is the predominant promised good or service, it cannot use that method as its default method whenever it has a performance obligation that includes a license of IP and other promised goods or services.

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Example 10-15: Identifying a method of measuring progress to completion for a performance obligation that includes a software license and installation services (Question 48 of the FASB RRI Q&As)

An entity promises to provide a software license and installation services that will substantially customize the software to add significant new functionality that enables the software to interface with other customized applications used by the customer. The entity concludes that the software and services are not separately identifiable from the customized installation service and the criterion in paragraph 606-10-25-19(b) is not met. Therefore, the software and installation service is combined into a single performance obligation. The entity also concludes that the performance obligation is satisfied over time. If the license was distinct, it would be considered a point in time license.

In the staff's view, the entity should use a measure of progress that depicts the performance of completing the customized software solution. All the revenue would be recognized over the period the customization services are performed.



RSM COMMENTARY: One of the views rejected by the FASB staff and TRG would have used an output method based on the value of each good or service transferred to the customer. One of the reasons this view was rejected was because it circumvented the reasons why the software license and installation services were bundled together as one performance obligation. The other view rejected by the FASB staff and TRG would have recognized all of the revenue upon transferring control of the software to the customer. The FASB staff and TRG rejected this view because it does not take into consideration the whole of what the customer contracted for, which is customized and installed software and not just software.



Example 10-16: Identifying a method of measuring progress to completion for a performance obligation that includes a franchise license and consulting services (Question 48 of the FASB RRI Q&As)

A franchisor enters into a 10-year license agreement with a new franchisee. The franchisor also promises to provide consulting services over the first year of the license agreement. The consulting services provide the franchisee with hours of service to help it set up operations to run its franchise.

For the purpose of this example, it is assumed that the franchisor concludes that the license and services should be combined into a single performance obligation because the license and services are highly interrelated (that is, each promise is capable of being distinct because the customer can derive some benefit from each item – from the franchise license on its own and the services together with the license granted upfront – but the promises are not distinct in the context of the contract). Furthermore, the entity concludes that the license is satisfied over time. The transaction price consists of an upfront fee of CU 1 million for the license and CU 150,000 for a fixed number of hours of consulting service that are performed in the first year.

In the staff's view, the entity should use a measure of progress that best depicts the performance of the license. The nature of the overall performance obligation is the franchisee's right to access the license and, therefore, the measure of progress would depict the transfer of the license. For example, using a time-based output method, the entire transaction price would be recognized ratably over the 10-year period. The entire transaction price of CU 1,150,000 would be recognized over the 10-year license agreement.

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RSM COMMENTARY: One of the views rejected by the FASB staff and TRG would have used a measure of progress depicting the performance of the consulting services in the first year of the license agreement. The FASB staff and TRG rejected this view because it essentially would ignore the right to access the IP subject to the license over the last nine years of the ten-year license period. The other view rejected by the FASB staff and TRG would have recognized the license fee over the license period and the consulting services fee as each hour of service is transferred to the customer. One of the reasons this view was rejected was because it circumvented the reasons why the franchise license and consulting services were bundled together as one performance obligation in the first place.

Note the example above assumes that the franchisor did not elect the practical expedient to account for certain pre-opening services as distinct (see Section 6.1.5).



Example 10-17: Identifying a method of measuring progress to completion for a performance obligation that includes a license of IP and when-and-if-available updates (ASC 606-10-55-364 to 55-366)

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

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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.

10Q.2.2.2 When an entity has performance obligations that include a license of symbolic IP and other distinct goods or services transferred upfront, and the transaction price includes both sales- or usage-based royalties and an upfront fee, how should the transaction price be allocated?

This scenario is most often seen in a franchise environment in which an entity will license its intellectual property for a period of time in exchange for a percentage of sales and also provide certain pre-opening services in exchange for an upfront fee. Under legacy GAAP, franchisors were not required to evaluate whether pre-opening services were a separate deliverable. However, as noted in the FASB's Update on Implementation Activities for Franchise Industry, the issuance of ASC 606 supersedes the previous industry-specific guidance for franchisors and requires that entities evaluate whether the pre-opening services are distinct (see Section 6.1) or elect a practical expedient in certain cases to account for pre-opening services as distinct (see Section 6.1.5). If the franchisor concludes that the franchise agreement includes multiple performance obligations, the entity must then determine whether the predominant item to which the sales- or usage-based royalty relates is the license of IP (see Question 7Q.3.5.1). If so, the entity can then exclude the royalties from the estimation of the transaction price and proceed with estimating the standalone selling price of the other promised goods and services in the contract in order to allocate the fixed consideration.

If the standalone selling price of the other goods and services is less than the upfront fee portion of the transaction price, the entity would allocate a portion of the fixed consideration to the goods and services based on their standalone selling price(s) and a portion to the license of IP. The portion allocated to the IP license would then be recognized over time using a reasonable measure of progress (see Scenario 1 in Example 10-18).

If the standalone selling price of the other goods and services is more than or equal to the upfront fee portion of the transaction price, the entity would recognize the full upfront fee when the related goods or services are transferred and would wait to recognize the royalties until the related sales or usage occurs, in accordance with the sales-and-usage-based royalties guidance, which requires revenue to be recognized at the later of: (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation (see Scenario 2 in Example 10-18).



Example 10-18: Allocating upfront fees in a franchise agreement with sales-based royalties

The following example is from the FASB's Update on Implementation Activities for Franchise Industry, which was discussed at a November 2017 Board meeting:

(a) A franchisee enters into a 10-year arrangement with a franchisor to open a restaurant location. The consideration comprises a $25,000 upfront fee and a royalty of 4 percent of future sales.

(b) The franchise agreement grants the franchisee the right to use the franchisor's intellectual property.

(c) Before opening the restaurant, the franchisor will provide various services related to the opening, such as site selection and training.

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Sales-Based Royalty

On the basis of the guidance in paragraph 606-10-55-65…the entity in the example does not estimate the royalties for the entire franchise period. The 4 percent royalty is allocated entirely to the license because the variable payment relates specifically to an outcome from the performance obligation to transfer the license. As such, the entity records revenue related to the 4 percent royalty as the customer's subsequent sales occur.

Identifying Performance Obligations

When implementing the new revenue standard, the common question in the fact pattern above has been whether the $25,000 fee relates to a single performance obligation for the license of intellectual property, which must be spread over the 10-year term of the arrangement, or whether the entire $25,000 fee may be allocated to separate performance obligations associated with the activities of the location opening, which would be recognized up front consistent with current GAAP. Because the allocation of revenue depends on determining whether the goods or services are distinct (which some, all, or none may be), as well as determining the standalone selling price for each distinct good or service, the answer may differ from franchisor to franchisor.

If the franchisor determines that some or all of the pre-opening services are distinct, then it would recognize revenue when (or as) those services are performed (i.e., typically up front). In this example, the entity determines that the training services are distinct because they are not highly interrelated with the franchise license. In this case, the entity determines that the training is not highly brand specific and consists principally of training that could be relevant to the operations of a similar business or businesses in general. In this example, the entity also determines that the site selection services are distinct from the license because they are not specific to the brand and could be provided by a third party. Next, the entity would need to determine the standalone selling price of the services that are separate performance obligations and allocate the transaction price to them based on the standalone selling prices.

Allocation/Standalone Selling Prices (Scenario 1)

…[T]he guidance does not prescribe a single method to determine standalone selling price. In applying the guidance on standalone selling price, the staff has considered how that analysis might be performed for training if it is considered a distinct performance obligation. The first step is to determine if the standalone selling price is observable (that is, the price charged if the entity provides any training services apart from the franchise license). For example, after the agreement for the franchise license, what would the franchisor charge to train new employees of the franchisee? Does the contract include a component of training for free for a minimal number of employees and then charge for additional employees (for example, free training for the first five employees but $X per additional employee)? If the entity does not have an observable standalone selling price for training, it might consider (a) the price that a third party typically charges for comparable education or (b) the cost of training plus an expected margin.

Consider that in this example a portion of the initial franchise fee, rather than the entire fee, is allocated to the pre-opening services (for example, $20,000). In this case, the entity determines that allocating the fixed consideration related to the standalone selling price of the pre-opening services and allocating a portion of the initial franchise fee and sales-based royalty to the license is consistent with the allocation objective.

Allocation/Standalone Selling Prices (Scenario 2)

Assume that the example above is modified so that the standalone selling prices of the pre-opening services is $30,000. Therefore, the standalone selling price of the pre-opening services ($30,000) is greater than the amount of the initial franchise fee ($25,000). In this case, the entity would recognize the entire fee ($25,000) as the pre-opening services are performed because the guidance does not allow

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pulling forward a portion of the future sales-based royalty (because of the guidance in paragraph 606-10-55-65).

10.3 Modifications and renewals of a license of IP

When a customer renews or extends a license of IP, revenue from that renewal cannot be recognized by the entity (licensor) until the start of the renewal period as noted in Section 10.2.1. Example 10-11 illustrates the outcome of a renewal of an existing license of IP in accordance with this guidance. However, ASC 606 does not contain explicit guidance on how to account for either of the following situations:

- Modification of an existing license of functional IP in which the term of the existing rights of that license was extended and new rights were added
- Options to revoke licensing rights in the future or convert the arrangement to a SaaS arrangement

In 2019, the EITF attempted to address these situations in Issue 19-B and discussed interpretations of ASC 606 that entities apply in practice. Although a final standard was not issued as result of the EITF's deliberations, we believe certain of these interpretations, which are discussed in Section 10.3.1 and Section 10.3.2, would generally be acceptable. The FASB may consider this issue further as part of the Post-Implementation Review process of ASC 606, though there is no active project on the Technical Agenda at the time of this publication.

10.3.1 Modifications that extend the term of the existing rights of the license of functional IP and grant additional rights

In these circumstances, entities have typically based their accounting treatment on either the guidance on renewals and new licenses of IP or the contract modifications guidance (see Section 5.5).

Entities that follow the guidance on renewals and new licenses of IP view the additional right (or new) rights granted in the arrangement as a new license of IP rather than a contract modification. This is due to the interpretation that the performance related to the existing license portion of the contract has already been completed and, therefore, cannot be modified. Since the new rights (extension of the term of the existing rights and the additional rights) granted in the updated arrangement are viewed as a new contract for a license of IP, the extension of the term of the existing rights would be treated similarly to a renewal, and the related revenue would not be recognized until the start of the renewal period. Under this interpretation, there may be no revenue recognized at the date the contract is modified.

Entities that follow the contract modification guidance would account for the license extension based on the substance of the contract modification. Due to the nature of a license of IP, the additional rights to use or access IP typically generate a distinct license from the original license of IP granted. Therefore, based on the guidance on contract modifications in Section 5.5, a modification could be accounted for as either a separate contract from the original agreement (in which it is accounted for separately from the original agreement as a new license of IP) or a termination of the original contract and the establishment of a new agreement (in which the modification is accounted for together with the remaining original license and unrecognized consideration, if any). If it is the latter, revenue would be recognized for both the renewal of the existing license and any additional licenses generated as a result of the additional rights granted on the modification date.

An entity should make an accounting policy election to select one of the interpretations and apply that interpretation consistently to similar arrangements. An entity should also disclose the accounting policy election chosen if it materially affects the financial statements.

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10.3.2 Options to revoke licensing rights in the future or convert the arrangement to a SaaS arrangement

Contracts for licenses of IP may be modified to include, or may include at inception, an option to revoke licensing rights in the future and convert the arrangement into a SaaS arrangement. Oftentimes, there is no additional payment required by the customer at the time of conversion.

The existence of a conversion option (whether implicit or explicit) from a license of IP to a SaaS arrangement should first be assessed to determine if the option is a material right (see Section 6.6.2). If the conversion option is not a material right, we believe the two approaches discussed by the FASB staff in Issue 19-B are acceptable. That is, an entity may account for the option as a right of return (see Section 7.3.6) or a prospective contract modification (see Section 5.5).

If accounting for the option as a right of return, an entity may limit the amount of revenue recognized for the license of IP to reflect an amount for the expected return of the license (i.e., conversion from a license to SaaS) with a corresponding refund liability. In situations in which the option to convert is elected, that liability would be derecognized with an offsetting entry to record revenue over the term of the SaaS arrangement.

If accounting for the conversion in accordance with the contract modification guidance, this may result in situations in which there is no remaining unrecognized consideration left to allocate to the remaining performance obligations in the new contract. This is due to the revenue recognition models for licenses of functional IP such as software (point in time) versus that of SaaS (over time). In those circumstances (i.e., if additional consideration was not part of the contract conversion), there would be no revenue recognized over the term of the SaaS arrangement.

While we believe either accounting treatment described above is acceptable, an entity should make an accounting policy election to select one of the interpretations and apply that interpretation consistently to similar arrangements. An entity should also disclose the accounting policy election chosen if it materially affects the financial statements.

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11. Principal vs. agent (i.e., gross vs. net)

The principal vs. agent guidance is only applied when another party is involved with the entity in providing the specified goods or services to the customer. When that is the case, there are two key steps in the principal vs. agent guidance:

- Identifying the specified goods or services being provided to the customer
- Determining whether the entity obtains control of the specified goods or services before transferring control of those goods or services to the customer

11.1 Identifying the specified goods or services

The same analysis used to identify the performance obligations in a contract also is used to identify the specified goods or services to which the principal vs. agent guidance is applied when another party is involved in providing those goods or services to the customer. As such, identifying the specified goods or services involves identifying all of the promises to provide goods or services in the contract and then determining whether those promised goods or services are distinct. The concept of distinct used for this purpose is the same as the concept of distinct used to identify performance obligations (see Section 6.2).

If a promise to provide a good or service is distinct, it is considered a specified good or service, and the entity must determine whether it is acting as a principal or an agent with respect to providing the good or service to the customer. If a promise to provide a good or service is not distinct, it is combined with one or more other promises to provide goods or services until the combined group is considered distinct. Each distinct group of promised goods or services is considered a specified good or service and the entity must determine whether it is acting as a principal or an agent with respect to providing that group of goods or services to the customer.

11.2 Determining whether the entity obtains control of a specified good or service

Once the specified goods or services have been identified, the entity must determine whether it controls each of the specified goods or services before they are transferred to the customer. If so, the entity is acting as a principal and should include the gross amount of consideration related to each of the specified goods or services in the transaction price (which is the amount ultimately recognized as revenue). If not, the entity is acting as an agent and should include the net fee or commission it expects to be entitled to for arranging to have another party provide the specified good or service to the customer in the transaction price. This may be the net amount it retains after collecting the gross amount from the customer and remitting part of that amount to the other party responsible for providing the good or service to the customer.

When another party is involved with the entity in providing the goods or services that make up a specified good or service to the customer, the entity is a principal with respect to the specified good or service in the following situations:

- The entity obtains control of a good or another asset from the other party and then transfers that good or other asset to the customer.
- The entity obtains control of a right to a service from the other party and has the ability to direct the other party in providing the service to the customer on the entity's behalf.
- The entity obtains control of a good or service (e.g., inputs) from the other party that the entity then combines with other goods or services to provide the specified good or service (e.g., outputs) to the customer.

For purposes of assessing whether the entity obtains control of the good, other asset, service and (or) right to a service that make up the specified good or service, the entity should consider whether it has the ability to direct the use of the specified good or service and receive substantially all of the related

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remaining benefits (which includes the entity being able to stop others from directing the use of the specified good or service and receiving substantially all of the related remaining benefits). This approach to determining whether the entity has control of the specified good or service before it is transferred to the customer is the same approach used to determine whether control of the goods or services underlying a performance obligation has transferred to the customer for purposes of satisfying a performance obligation and recognizing revenue (see Section 9.1).

In some cases, an analysis of the facts and circumstances will conclusively show that the entity has the ability to direct the use of the specified good or service and receive substantially all of the related remaining benefits (see Example 11-3). In other situations in which the analysis of the facts and circumstances does not conclusively show that the entity has the ability to direct the use of the specified good or service and receive substantially all of the related remaining benefits, the entity should consider the following indicators:

- *Primary responsibility for fulfillment.* If the entity (and not the supplier) is primarily responsible to the customer for fulfillment of the specified good or service, then that supports the entity obtaining control of the specified good or service before it is transferred to the customer. Having primary responsibility for fulfillment typically involves being responsible for the acceptability of the specified good or service (e.g., being responsible for the specified good or service meeting customer specifications). If the entity is nominally responsible to the customer for the specified good or service's acceptability but is eligible for reimbursement from the supplier for any compensation given to the customer, this may point to the supplier as having primary responsibility for fulfilment rather than the entity.
- *Inventory risk.* If the entity has inventory risk before or after the specified good or service is transferred to the customer, then that supports the entity obtaining control of the specified good or service before it is transferred to the customer. The nature of the inventory risk should be considered in assessing the weight this indicator should carry in the overall evaluation of whether the entity has obtained control of the specified good or service. For example, legal title to inventory briefly passing to the entity before it passes to the customer should carry little, if any, weight in the overall evaluation. Conversely, cases such as the following should carry more weight in the overall evaluation:
  - The entity obtains control of inventory from a vendor before it enters into a contract to sell that inventory to its customer and there is no right to return that inventory for a refund.
  - The entity commits to obtain control of inventory or a service from a vendor before it enters into a contract to sell that inventory or service to its customer and there is no right to either receive a refund for any amounts paid or avoid paying those amounts due to the vendor.
- *Discretion in setting prices.* If the entity (and not the supplier) has discretion in setting the price paid by the customer for the specified good or service, then that may support the entity obtaining control of the specified good or service before it is transferred to the customer. However, it is not uncommon for an agent to have some discretion in setting the price paid by the customer.

With respect to using these indicators in the overall evaluation of whether the entity obtains control of a specified good or service, the FASB indicated the following in paragraph BC16 of ASU 2016-08:

> 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.

The significance of a particular indicator depends on the facts and circumstances, including the nature of the specified good or service and the contract terms. As such, reaching an appropriate conclusion about whether revenue should be recognized as a principal or an agent will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

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As noted by Sheri L. York, a professional accounting fellow in the SEC's Office of the Chief Accountant, at the 2018 AICPA Conference on Current SEC and PCAOB Developments, the need for significant judgment does not mean optionality. Rather, entities should apply a rigorous analysis in order to faithfully apply the principal-versus-agent analysis to their specific facts and circumstances.

11Q.2.1 Does an entity control a specified good if legal title transfers to it for just a moment before legal title transfers to the customer?

Whether an entity controls a specified good is based on an evaluation of all the facts and circumstances, only one of which is whether the entity momentarily holds legal title before it transfers to the customer. The entity's objective is to determine whether it has the ability to direct the use of the specified good and receive substantially all of the related remaining benefits (including the ability to stop others from directing the use of the specified good and receiving the related remaining benefits). That objective would not be satisfied if the only fact supporting control transfer was the entity momentarily holding legal title before it transfers to the customer.

11Q.2.2 Is an entity determining whether it is a principal or an agent at the contract level or the specified good or service level?

Specified good or service level. In a particular contract, there may be some specified goods or services for which the entity is acting as a principal (and recognizing revenue gross) and others for which it is acting as an agent (and recognizing revenue net).

11Q.2.3 Can an entity be considered the principal without obtaining physical possession of the specified good?

Yes. As noted by Sheri L. York, a professional accounting fellow in the SEC's Office of the Chief Accountant, at the 2018 AICPA Conference on Current SEC and PCAOB Developments, inventory risk is only one of the possible indicators and there will be some circumstances in which an entity will obtain control of a specified good without physical possession. The SEC staff noted that evaluating whether an entity is acting as the principal or an agent when the entity never obtains physical possession (e.g., when goods are shipped directly from a manufacturer to a third party) can be challenging, and a careful analysis of the facts and circumstances will be necessary.



Example 11-1: Determining whether the entity is acting as a principal or agent for direct shipments

The following example is from Sheri L. York's Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments:

[A] 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.

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In this fact pattern, the staff did not object to the registrant's conclusion that it was the principal in the transaction.

11Q.2.4 Can inventory risk exist with respect to a specified service?

Yes. While no physical goods may be delivered in connection with a specified service, inventory risk can still exist. For example, if an entity makes a nonrefundable prepayment to a third-party service provider for the specified service before it has entered into a contract with the customer, the entity has inventory risk.



Example 11-2: Determining whether the entity is acting as a principal or agent for website sales (ASC 606-10-55-317 to 55-319)

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.

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.

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.

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.

As part of reaching that conclusion, the entity considers the following indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control the specified goods before they are transferred to the customers.

a. The supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. The entity is neither obliged to provide the goods if the supplier fails to transfer the goods to the customer nor responsible for the acceptability of the goods.

b. The entity does not take inventory risk at any time before or after the goods are transferred to the customer. The entity does not commit to obtain the goods from the supplier before the goods are purchased by the customer and does not accept responsibility for any damaged or returned goods.

c. The entity does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.

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

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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.



RSM COMMENTARY: This example illustrates the overall concept that an entity must obtain control of the specified goods or services before they are transferred to the customer to be in a position to conclude that it should recognize revenue as a principal. Because the entity in this example does not obtain control of the products the customers are buying from the suppliers, it should recognize revenue net for the commission to which it is entitled for essentially acting as an agent to bring the suppliers (who are the entity's customers) together with the suppliers' customers.

If the facts in this example had been such that legal title transferred to the entity momentarily before legal title transferred to the customer, the conclusion would still be that the entity does not control the product before it is transferred to the customer given the number and strength of other facts in existence that continue to support that conclusion.

It is also worth noting that when revenue is recognized in this example depends on when the entity transfers control of the agency service it is providing to the suppliers, which may be different from when control of the goods transfers to the customers, depending on the facts and circumstances.



Example 11-3: Determining whether the entity is acting as a principal or agent for specialized equipment when a subcontractor is involved (ASC 606-10-55-320 to 55-324)

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.

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.

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.

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.

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

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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.

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.

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.



RSM COMMENTARY: If the entity had not outsourced the manufacture of the specialized equipment to a subcontractor, it would not have had to consider the principal vs. agent guidance.

This example illustrates the considerations involved in identifying the specified goods or services that should be evaluated for purposes of applying the principal vs. agent guidance. In this example, the entity must consider whether manufacturing the equipment (i.e., the good or service provided by the other party) is distinct from the other goods and services provided by the entity to produce the specialized equipment (e.g., services to design the specialized equipment, overall integration service). Because manufacturing the equipment was not considered distinct from the services provided by the entity, there is one specified good or service in this example, and it is the specialized equipment. The analysis performed to determine whether the entity should recognize revenue as a principal or agent for that one specified good or service would be very different from the analysis it would perform to determine whether it should recognize revenue as a principal or agent for two specified goods or services—one for the manufacturing of the specialized equipment by the supplier and one for the other goods and services provided by the entity. Different analyses could produce different answers with respect to whether the entity is acting as a principal or agent, which illustrates the importance of the entity carefully considering all the facts and circumstances in reaching an appropriate conclusion about the specified goods or services that exist in any given situation.

This example also illustrates a situation in which only the overall concept of control needed to be considered in reaching a definitive conclusion with respect to whether the entity controlled the specialized equipment before it transferred to the customer. In most cases, however, we would expect that an entity will need to also consider the principal vs. agent indicators to arrive at a conclusion with respect to whether the entity controls the specified good or service before it is transferred to the customer.

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Example 11-4: Determining whether the entity is acting as a principal or agent for office maintenance services (ASC 606-10-55-324A to 55-324G)

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.

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.

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.

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.

The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph 606-10-55-37A(b)). In addition, the entity concludes that the following indicators in paragraph 606-10-55-39 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:

a. The entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (that is, the entity is responsible for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).

b. The entity has discretion in setting the price for the services to the customer.

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.

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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 11-5: Determining whether the entity is acting as a principal or agent for airline tickets (ASC 606-10-55-325 to 55-329)

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.

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.

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.

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.

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.



RSM COMMENTARY: Refer to Example 11-6 and the related RSM commentary.

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Example 11-6: Determining whether the entity is acting as a principal or agent for restaurant vouchers (ASC 606-10-55-330 to 55-334)

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 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.



RSM COMMENTARY: This example illustrates the need to consider whether the specified good or service is the right to a meal or the actual meal itself. If the entity in this example inappropriately identified the specified good or service as the meal, its analysis to determine whether it obtains control over the meal itself would be different from the analysis to determine whether it obtains control over the right to a meal. Moreover, these different analyses could

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produce different conclusions with respect to whether the entity is acting as a principal or an agent.

Example 11-5 illustrates a similar situation that addresses whether the entity is a principal or an agent with respect to an airline ticket (i.e., right to fly). One key difference in that example is that the entity buys the rights to flights prior to having customers that have committed to buying those rights to flights (i.e., it has inventory risk for the rights to flights). That fact plays a key role in the entity in that example concluding it controls the rights to flights before those rights transfer to the customer, resulting in it recognizing revenue for the rights to flights it sells as a principal. In comparing and contrasting Example 11-5 to this example, if the entity in this example had inventory risk for the restaurant vouchers it sells to customers, it likely would conclude it controls the rights to meals before they are transferred to the customers, resulting in recognizing revenue for those rights to meals as a principal. However, all the facts and circumstances would need to be carefully considered in a reaching a final conclusion about whether the entity is acting as a principal or agent.



Example 11-7: Determining whether the entity is a principal or agent for recruiting services (ASC 606-10-55-334A to 55-334F)

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.

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.

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.

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.

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).

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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.

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.



RSM COMMENTARY: This example illustrates that: (a) an entity determines whether it is a principal or an agent at the specified good or service level and not the contract level and (b) an entity may be a principal for one specified good or service in a contract and an agent for another specified good or service in the same contract.



Spotlight on change

The approaches used in the principal vs. agent guidance in legacy GAAP and ASC 606 are fundamentally different. Legacy GAAP provided eight indicators that an entity was acting as a principal, and three indicators that an entity was acting as an agent. For purposes of determining whether an entity was acting as a principal or an agent under legacy GAAP, the analysis focused solely on these indicators in the context of a specific set of facts and circumstances. While ASC 606 incorporates consideration of three indicators, its overall focus is on whether the entity obtains control of the promised good or service before it is transferred to the customer. The three indicators included in ASC 606 are only considered if the control analysis is inconclusive. In addition, while legacy GAAP weighted some indicators as having more influence on the overall conclusion than others, no such weighting is provided for the three indicators in ASC 606. While we do not expect the fundamental difference between legacy GAAP and ASC 606 to result in a different outcome in most situations, an entity still needs to apply the principal vs. agent guidance in ASC 606 to its facts and circumstances to determine if a different outcome is warranted.

11.3 Another entity assumes the entity's performance obligation and contractual rights

Consider a situation in which another entity assumes the entity's: (a) performance obligation to transfer specified goods or services to the customer and (b) the entity's contractual rights to consideration from the customer for doing so. As a result of the other entity assuming the performance obligation and contractual rights, the entity no longer is obligated to satisfy the performance obligation, nor is the entity any longer entitled to any consideration related to doing so. Because the entity is not satisfying the performance obligation, it does not recognize the related revenue. If the entity was acting as an agent to obtain the related contract for the other party that ultimately assumed the contract, it may be appropriate for the entity to recognize a separate fee as revenue for satisfying the performance obligation related to obtaining the contract for the other party, depending on the facts and circumstances.

11.4 Difference between performance obligations and specified goods or services

As mentioned earlier, the same analysis used to identify the performance obligations in a contract is also used to identify the specified goods or services to which the principal vs. agent guidance is applied when another party is involved in providing those goods or services to the customer. The difference between performance obligations and specified goods or services arises from the incremental control analysis an entity must perform when another party is involved in providing the specified goods or services to the

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customer. If this analysis results in the entity concluding that it has obtained control of the specified goods or services before transferring control to the customer, then the performance obligations are to transfer the specified goods or services. Conversely, if this analysis results in the entity concluding that it has not obtained control of the specified goods or services before transferring control to the customer, then the performance obligation is to arrange for those specified goods or services to be provided to the customer by the other party rather than to transfer the specified goods or services to the customer.

11.5 Estimating Gross Revenue as a Principal

There may be situations in which an entity that is a principal in a revenue transaction does not and will not know the ultimate price paid by its customer. This can occur in situations in which the entity sells a product to an intermediary that is considered an agent of the entity and this intermediary then subsequently sells the product to an end-user that is considered the entity's customer. The customer then remits payment to the intermediary for the product while the intermediary only pays the entity a net amount after withholding the fees it earned as an intermediary. If the arrangement between the intermediary and the entity allows the intermediary control over the prices charged to end-users and does not require any reporting of the prices charged, the ultimate price paid by end-users will not be known by the entity.

The question arising in this scenario is whether the entity must estimate the price paid by the end user to determine the transaction price and the gross amount of revenue to record. While this question was not addressed in the authoritative guidance, the FASB did address this issue in paragraphs BC37 and BC38 of ASU 2016-08. Paragraph BC38(c) notes the following: "The determination of whether revenue may be estimated or not is based on an assessment of the transaction price guidance in Section 606-10-32 on measurement (such as, the amount of consideration which the entity expects to be entitled to for transferring promised goods or services to a customer and the constraint on variable consideration). The guidance on variable consideration is instructive as to whether amounts should be recognized as revenue. 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." Based on this guidance, we believe in scenarios in which the ultimate price paid by the customer to the intermediary will never be known by the entity, the entity should not estimate that gross amount (and offsetting expense). Rather, the transaction price (and hence revenue to be recorded) should be based on the amounts received or to be received by the entity from the intermediary.

11.6 Determining revenue recognition timing for an agent

As discussed in Section 11.2, when an entity determines it does not control each of the specified goods or services before they are transferred to a customer, the entity is acting as an agent. The timing of revenue recognition in this scenario is based on when control of the agent's performance obligation to arrange to have another party provide the specified good or service transfers, rather than when control of the specified goods or services transfers. The agent may satisfy its performance obligation prior to control of the specified goods or services being transferred by the principal to the customer.

Paragraph BC383 of ASU 2014-09 illustrates the following example of when this might occur: "…an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

a. The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.

b. The points entitle the customers to future discounted purchases with another party (that is, the points represent a material right to a future discount).

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c. The entity determines that it is an agent (that is, its promise to arrange for the customers to be provided with points) and the entity does not control those points before they are transferred to the customer."

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12. Onerous contracts

12.1 General

ASC 606 does not provide guidance on how to account for onerous (i.e., loss) contracts. However, existing guidance in legacy GAAP that addresses certain types of onerous contracts was retained. In some cases, this guidance was amended to reflect the fact that ASC 606 and ASC 340-40 will factor into the determination as to whether a contract is onerous, and if so, the amount of loss that is recognized. The guidance related to accounting for certain types of onerous contracts is listed in the following table:

ASC	Type of onerous contract
605-20	Separately priced extended warranty and product maintenance (see Section 12.2)
605-35	Construction-type and production-type (see Section 12.3)
912-20-45-5	Federal government (Note 1)
954-440-35-1 to 35-3	Continuing care retirement community (Note 1)
954-450-30-3 to 30-4	Prepaid health care services (Note 1)
980-350-35-3	Long-term power sales contracts (Note 1)
985-605-25-7	Software or software systems for which there is significant production, modification or customization of the software (see Section 12.4)

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and (or) its contracts.

12.2 Loss provisions on separately priced extended warranty and product maintenance contracts

12.2.1 Scope

A separately priced extended warranty and product maintenance contract (extended warranty and maintenance contract) is a contract the entity and customer enter into that is separate from the contract they entered into related to the customer's purchase of the underlying product (product contract). As a result, the pricing for the extended warranty and maintenance contract is not included in the pricing for the related product. In addition, the warranty included in such a contract goes beyond the standard warranty the entity provides in every product sale (see Section 6.5). While the product contract and the extended warranty and maintenance contract often are entered into at the same time, they do not have to be for the loss provision guidance in ASC 605-20 to apply. In addition, while the customer usually enters into the extended warranty and maintenance contract with the same entity with which it entered into the product contract, this does not have to be the case for the loss provision guidance to apply to the extended warranty and maintenance contract.

As discussed in Section 6.5, there are two types of warranties for revenue recognition purposes: (a) assurance-type warranties and (b) service-type warranties. Separately priced extended warranty and product maintenance contracts are considered service-type warranties that should be accounted for separately as performance obligations. Additional information about accounting for assurance-type and service-type warranties is provided in Section 6.5.

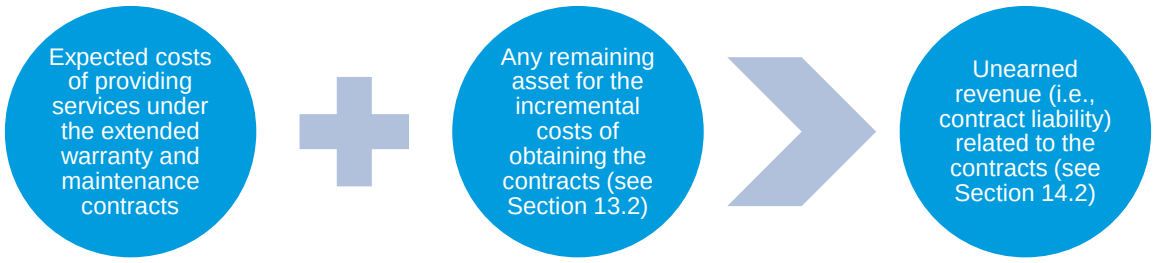
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12Q.2.1.1 Is a contract for a service-type warranty that is not separately priced subject to the loss provision guidance in ASC 605-20?

No. The loss provision guidance in ASC 605-20 is only applicable to separately priced service-type warranties. If there is only one price for both a product and the related service-type warranty, the loss provision guidance in ASC 605-20 does not apply to the service-type warranty.

12.2.2 Recognition and measurement

A loss provision should be recognized for a group of separately priced extended warranty and product maintenance contracts when:



For purposes of determining whether a loss exists, the entity should use a consistent approach to grouping contracts.

To the extent a loss provision is recognized, it is first used to reduce to zero any remaining balance in the asset for the incremental costs of obtaining the contracts. If the loss provision exceeds any remaining balance in the asset for the incremental costs of obtaining the contracts, the excess loss provision is recognized as a liability.



Example 12-1: Accounting for a loss provision on a group of separately priced extended warranty contracts

On January 1, 20X1, Company A (an electronics retailer) sold ten televisions to ten different customers for $3,000 each. At the same time, Company A also entered into a separately priced extended warranty contract with each of those ten customers for an additional nonrefundable payment of $360 per contract. The duration of the contract is 36 months, and the contract does not provide the customer with a right of renewal. All ten contracts have the same terms. Company A estimates it will incur costs of $700 each year performing under all ten of the separately priced extended warranty contracts. In addition, for every separately priced extended warranty contract sold, Company A pays the salesperson a commission of $60.

Based on this information, Company A expects to earn a gross profit of $900 ([$360 per contract × 10 contracts] – [$700 annual costs × 3 years] – [$60 commission per contract × 10 contracts]) on the ten separately priced extended warranty contracts it entered into on January 1, 20X1.

Company A applies ASC 606 to its facts and circumstances, and the results of doing so specifically with respect to the separately priced extended warranty are as follows:

- The transaction price allocated to each extended warranty services performance obligation is $360 (for ease of illustration, the standalone selling prices of the television and extended warranty services were assumed to be the same as the contract prices) (see Chapter 8).
- The extended warranty services performance obligation is satisfied over time and a straight-line method will be used to measure the progress toward complete satisfaction of the performance

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obligation given that the related costs are expected to be incurred evenly over the three-year term of the contract (see Chapter 9).

In addition, Company A applies ASC 340-40 to its facts and circumstances (see Chapter 13), which results in it: (a) capitalizing the $600 in commissions it paid to its salespeople to originate the ten separately priced extended warranty contracts and (b) amortizing the $600 of capitalized commission costs over three years using the same method (i.e., straight line) used to recognize the related revenue.

On January 1, 20X1, Company A records the following journal entry related to the ten separately priced extended warranty contracts:

	Debit	Credit
Cash (Note 1)	$3,600	
Capitalized commissions (Note 2)	600	
Contract liability (Note 3)		$3,600
Commissions payable (Note 2)		600

Note 1: 10 separately priced extended warranty contracts × $360 price per contract

Note 2: 10 separately priced extended warranty contracts × $60 commission per contract

Note 3: 10 extended warranty services performance obligations × $360 allocated transaction price per performance obligation

At the end of 20X1, Company A was forced to renegotiate the contract with its labor union. As a result, the actual costs incurred in 20X1 related to all ten of the extended warranty services performance obligations increased to $1,250 due to wage increases being retroactively effective back to January 1, 20X1. In addition, Company A revises its estimates of the costs it expects to incur related to those performance obligations in 20X2 and 20X3 to $1,250 per year (for total costs over all three years of $3,750). The following journal entry illustrates Company A's accounting for the revenue and costs related to the ten separately priced extended warranty contracts in 20X1:

	Debit	Credit
Contract liability (Note 1)	$1,200	
Contract costs (Note 2)	1,450	
Revenue (Note 1)		$1,200
Capitalized commissions (Note 3)		200
Accounts payable (Note 4)		1,250

Note 1: $3,600 allocated transaction price for all ten of the extended warranty services performance obligations ÷ three-year contract term

Note 2: $1,250 costs incurred in 20X1 related to all ten of the extended warranty services performance obligations + $200 amortized commissions (Note 3)

Note 3: $600 capitalized commissions ÷ three-year contract term

Note 4: Accounts payable was used here for ease of illustration. Other accounts could be affected as Company A incurred the $1,250 of costs related to the extended warranty services performance obligations, including cash (e.g., payments for labor costs) and parts inventory.

Given the significant increase in the costs it expects to incur to perform under the separately priced extended warranty contracts, Company A performs an analysis to determine whether a loss provision

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should be recognized for those contracts. For ease of illustration, it is assumed that Company A groups its separately priced extended warranty contracts by the date they were entered into for purposes of determining whether a loss provision should be recognized. The following table captures Company A's analysis:

Expected costs of providing services under the separately priced extended warranty contracts ($1,250 in 20X2 + $1,250 in 20X3)	$2,500
The remaining asset for capitalized commissions ($600 beginning balance – $200 amortization recognized in 20X1)	400
Total	2,900
Contract liability related to the separately priced extended warranty contracts ($3,600 beginning balance – $1,200 revenue recognized in 20X1)	2,400
Excess of expected costs and capitalized commissions over the contract liability (i.e., loss provision)	$500

Based on this analysis, Company A concludes that it should recognize a loss provision of $500. To do so, Company A records the following journal entry:

	Debit	Credit
Loss provision	$500	
Capitalized commissions (Note 1)		$400
Liability for loss provision (Note 1)		100

Note 1: Because the loss provision of $500 is more than the $400 remaining balance of capitalized commissions, the capitalized commissions balance is first reduced to zero and the excess loss provision of $100 is recognized as a liability.

12.3 Loss provisions on construction-type and production-type contracts

12.3.1 Scope

ASC 605-35-15-2(a) indicates that the scope of the guidance in ASC 605-35 related to recognizing loss provisions on a contract applies to the following types of contracts entered into by contractors:

> The performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph 605-35-15-3 for examples). Contracts covered by this Subtopic are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications. Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be buyer's specifications.

For these purposes: (a) a contractor may be a general or prime contractor, a subcontractor or a construction manager and (b) a contract is a binding agreement between the contractor and its customer under which the contractor will provide a service to the customer's specifications.

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The following table includes two lists of contracts that are examples of when the loss provision guidance in ASC 605-35 does and does not apply (neither list is all inclusive):

Examples of contracts to which the loss provision guidance in ASC 605-35…	
Does apply	**Does not apply**
From ASC 605-35-15-3: a. Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving). In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, this Subtopic also would be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. b. Contracts to design and build ships and transport vessels. c. Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts. d. Contracts for construction consulting service, such as under agency contracts or construction management agreements. e. Contracts for services performed by architects, engineers, or architectural or engineering design firms. f. Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software.	From ASC 605-35-15-6: a. Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as the sale of goods and if their costs are accounted for in accordance with generally accepted principles of inventory costing. b. Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time. c. Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts. d. Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period. e. Magazine subscriptions. f. Contracts of not-for-profit entities (NFPs) to provide benefits to their members over a period of time in return for membership dues. g. Contracts for which other Topics in the Codification provide special methods of accounting, such as leases. h. Cost-plus-fixed-fee government contracts, which are discussed in Topic 912, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. i. Federal government contracts within the scope of that Topic. j. Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use entity resources that do not alone produce a tangible commodity or product as the principal intended result (for example, services, not plans, are usually the principal intended result in a transaction between an architect and the customer of an architect).

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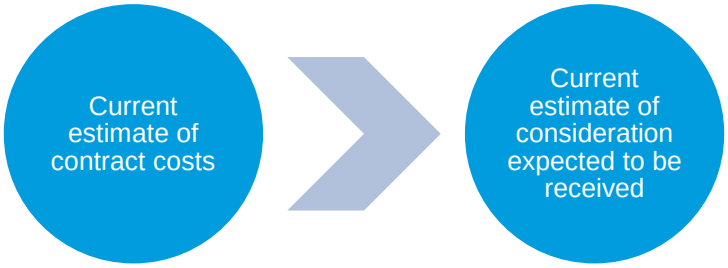
12.3.2 Recognition and measurement

A contractor may elect to recognize and measure loss provisions on contracts within the scope of ASC 605-35 at one of the following two levels:

1. *Contract level (or combined contract level)*. The contract (or combined contracts) is the unit of account for which a loss provision is recognized and measured (when necessary). Combined contracts should only be the unit of account if the contracts were combined as a result of applying the contract combination guidance in ASC 606 (see Section 5.4). If loss provisions are recognized and measured at this level, more than one performance obligation may be affected.
2. *Performance obligation level*. The performance obligation is the unit of account for which a loss provision is recognized and measured (when necessary).

The same accounting policy must be applied to similar contracts.

If a contractor anticipates a loss on a particular unit of account, the entire anticipated loss should be recognized and measured by the contractor in the period the loss becomes evident. A loss provision is recognized and measured when:



The entire loss is recognized in the period it becomes evident.

12Q.3.2.1 Can a loss provision arise on a cost-type contract?

Yes. A loss provision can arise on a cost-type contract if the amount of guaranteed reimbursable costs has a ceiling (which the contractor expects to exceed) or if there are target penalties (which the contractor expects to incur).

12.3.2.1. Current estimate of contract costs

The current estimate of contract costs should include all of the fulfillment costs allocable to a contract (see Section 13.1). For its cost-plus contracts, a contractor also should consider whether any nonreimbursable costs should be included in the current estimate of contract costs. For all its contracts, the contractor should consider whether there are any costs associated with change orders accounted for as contract modifications (see Section 5.5) that should be included in the current estimate of contract costs. In addition, for purposes of determining its total cost overrun on a contract, the contractor should use its normal cost accounting methods.

12.3.2.2 Current estimate of consideration expected to be received

The current estimate of consideration expected to be received is determined in accordance with ASC 606 and depends on whether the unit of account for recognizing and measuring a loss provision is the:

- *Contract (or combined contracts)*. The current estimate of consideration expected to be received is the transaction price for the contract (or combined contracts) (see Chapter 7) reduced by the amount the contractor does not expect to collect from the customer due to its credit risk (see Section 5.2.1 for discussion of how credit risk is addressed in ASC 606) and increased by the effects of removing the variable consideration constraint (if any) (see Section 7.3.3).

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- *Performance obligation*. The contractor allocates the current estimate of consideration expected to be received for the contract (or combined contracts) to the performance obligations using the guidance in ASC 606 on allocating the transaction price to the performance obligations (see Chapter 8), which results in the current estimate of consideration expected to be received for each performance obligation.

It would not be uncommon for a contractor to incur a performance penalty in a situation in which it expects to incur a loss on a particular unit of account. If the contractor recognizes a loss provision for a particular unit of account, it should include any related performance penalty. A contractor also should consider other forms of variable consideration (e.g., target rewards, potential price redeterminations) and whether there is any consideration associated with change orders accounted for as contract modifications (see Section 5.5) that should be included in the current estimate of consideration expected to be received.



Example 12-2: Accounting for a loss provision on a construction contract

Contractor A enters into a contract with Customer B on September 1, 20X1 to build a new hospital for $100 million. Contractor A sets a completion date for the hospital of August 31, 20X4 and estimates that it will incur total construction costs of $85 million. The schedule by which Contractor A bills the $100 million transaction price is as follows:

Billing date	20X1	20X2	20X3	20X4
March 1	$ -	$7,000,000	$7,000,000	$7,000,000
June 1	-	7,000,000	7,000,000	7,000,000
September 1	7,000,000	7,000,000	7,000,000	16,000,000
December 1	7,000,000	7,000,000	7,000,000	-
Annual total	$14,000,000	$28,000,000	$28,000,000	$30,000,000
Contract total				$100,000,000

Customer B is obligated to pay the amounts billed by Contractor A within 60 days of the billing date. In addition, if Contractor A finishes construction of the hospital by May 31, 20X4 (which is three months ahead of its scheduled completion), Customer B will pay Contractor A an additional $8 million. Based on Contractor A's past success with finishing construction of similar hospitals earlier than the established completion date, Contractor A believes there is a better than 50 percent likelihood it will finish the hospital three months early and be entitled to the additional $8 million of consideration. Said differently, Contractor A's estimate of variable consideration using the most likely amount method is $8 million. However, in applying the variable consideration constraint, Contractor A does not believe it is probable that including the additional $8 million in the transaction price will not result in a significant reversal of cumulative revenue recognized upon resolution of the uncertainty related to when the hospital will be completed. As a result, Contractor A does not include the variable consideration of $8 million in the transaction price (i.e., the variable consideration of $8 million is fully constrained).

Customer B already owns the land on which the hospital will be built. Based on its facts and circumstances, Contractor A appropriately concludes: (a) the contract includes a single performance obligation (see Example 6-7), (b) the contract is satisfied over time because control of the hospital transfers to Customer B as it is built by Contractor A and (c) the cost-to-cost method will be used to measure its progress toward completion of the hospital.

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December 31, 20X1

As of December 31, 20X1 (its calendar year end), Contractor A has: (a) incurred construction costs of $8.5 million, (b) received the September 1 payment of $7 million from Customer B and (c) not yet received the December 1 payment of $7 million from Customer B. In addition, Contractor A continues to estimate that it will incur total costs of $85 million. Contractor A also continues to reach the same conclusions with respect to finishing the hospital three months early and being entitled to the variable consideration, which results in the variable consideration continuing to be constrained.

The following journal entry illustrates the effects of Contractor A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	$7,000,000	
Accounts receivable	7,000,000	
Costs of construction	8,500,000	
Revenue (Note 1)		$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: $100,000,000 transaction price × ($8,500,000 construction costs incurred ÷ $85,000,000 total construction costs expected to be incurred)

Note 2: The contract liability represents the difference between: (a) Customer B's performance ($7 million payment) and obligation to perform ($7 million obligation to pay) and (b) Contractor A's performance ($10 million) (see Section 14.2).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Contractor A incurred the $8.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

March 31, 20X2

Due to a natural disaster in the geographic location of Contractor A's primary supplier of construction materials, there has been a significant decrease in the availability of construction materials from this supplier. In addition, because of the damage to hospitals and other facilities in the geographic location affected by the natural disaster, there has been an increase in the demand for construction materials and experienced construction workers. This increase in demand and decrease in supply has caused Contractor A's estimate of the costs it expects to incur to complete the construction of the hospital to increase to $105 million. Contractor A has not yet determined whether it will be able to seek additional compensation from Customer B to help cover the increased costs of building the hospital.

As of March 31, 20X2, Contractor A has: (a) incurred total construction costs to date of $21 million, (b) received the December 1, 20X1 payment of $7 million from Customer B and (c) not yet received the March 1, 20X2 payment of $7 million from Customer B. Contractor A continues to apply the most likely amount method for purposes of estimating the amount of variable consideration to which it expects to be entitled. Despite the natural disaster, Contractor A continues to believe there is a greater than 50 percent likelihood that it will finish the hospital three months early because it plans to redirect certain resources from other construction projects to the construction of Customer B's hospital. However, due to the effects of the natural disaster, Contractor A is not able to conclude that it is probable that including the $8 million in the transaction price will not result in a significant reversal of cumulative revenue recognized upon resolution of the uncertainty related to when the hospital will be completed. As a result, Contractor A does

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not include the variable consideration of $8 million in the transaction price (i.e., the variable consideration of $8 million is fully constrained).

The following journal entry illustrates Contractor A's accounting for the revenue and costs related to its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	$7,000,000	
Costs of construction (Note 1)	12,500,000	
Contract liability (Note 2)	3,000,000	
Revenue (Note 3)		$10,000,000
Accounts payable (Note 4)		12,500,000

Note 1: $21,000,000 total construction costs incurred to date – $8,500,000 construction costs incurred in prior periods

Note 2: The balance in the contract liability should be $1 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and (b) Contractor A's performance of $20 million ($10,000,000 of revenue recognized in 20X1 + $10,000,000 of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by $3 million.

Note 3: ($100,000,000 transaction price × [$21,000,000 total construction costs incurred to date ÷ $105,000,000 total construction costs expected to be incurred]) – $10,000,000 recognized as revenue in prior periods

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Contractor A incurred the $12.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

Because of the increase in total expected construction costs, Contractor A performs the following analysis to determine whether it should recognize a loss provision related to its contract with Customer B:

Current estimate of consideration expected to be received:	
Transaction price for the contract	$100,000,000
Less the amount the entity does not expect to collect from the customer due to its credit risk (At March 31, 20X2, Contractor A believes it has no credit risk with respect to Customer B.)	-
Plus the effects of removing the variable consideration constraint	8,000,000
	108,000,000
Current estimate of contract costs	105,000,000
Estimated profit (loss) on the contract	$3,000,000

Based on this analysis and the facts provided, Contractor A should not recognize a loss provision.

Assume the facts were changed such that Contractor A was not able to redirect resources to the construction of Customer B's hospital, causing Contractor A to conclude there was no longer a greater than 50 percent likelihood that it will finish the hospital three months early. Based on that change in facts, the estimated amount of variable consideration to which Contractor A would expect to be entitled would be zero *before* applying the variable consideration constraint. As a result, the variable consideration would not be added to the transaction price to arrive at the current estimate of consideration expected to

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be received for purposes of determining whether a loss provision should be recognized. Instead, the current estimate of consideration expected to be received would be $100 million, which would result in Contractor A recognizing a loss provision of $5 million. Given the significant accounting consequences of concluding whether there is a greater than 50 percent likelihood of Contractor A finishing the hospital three months early, Contractor A should carefully consider all of the facts and circumstances in the context of the variable consideration guidance in ASC 606 and the loss provision guidance in ASC 605-35.

12.3.3 Presentation of loss provision

The loss provision for a unit of account should be presented as an additional contract cost on the income statement and should not be: (a) presented as a reduction of revenue or (b) classified as a separate line item on the income statement unless the amount of the loss is material or the nature of the loss is unusual or infrequent. In those limited situations in which the loss is classified as a separate line item on the income statement, it should still be included in the determination of gross profit.

To the extent a significant liability is recognized related to a loss provision, it should be separately presented on the balance sheet. However, if there are costs accumulated on the balance sheet related to the unit of account, a contractor may choose to recognize the loss provision for that unit of account as a reduction of the accumulated costs instead of recognizing it as a liability. When a separate liability is presented on the balance sheet for a loss provision, it should be classified as a current liability.

12.4 Loss provisions on certain contracts to deliver software or a software system

12.4.1 Scope

The guidance in ASC 985-605 applies to contracts to deliver software or a software system for which significant production, modification or customization of the software is required. The contract may only include the software or software system or it may also include other products and services.

12.4.2 Recognition and measurement

The loss provision guidance in ASC 605-35 (see Section 12.3) is used to account for and present loss provisions on contracts to deliver software or a software system for which significant production, modification or customization of the software is required (i.e., contracts within the scope of ASC 985-605). However, an entity also should recognize a loss provision on a partially or fully unsatisfied performance obligation under ASC 450 to the extent it becomes probable that the amount of the transaction price allocated to that performance obligation will result in the entity recognizing a loss on that performance obligation.

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13. Contract costs

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The two categories of costs addressed in ASC 340-40 include: (a) costs to fulfill a contract and (b) costs to obtain a contract.

13Q.1 Does ASC 340-40 address when to recognize the costs within its scope?

No. ASC 340-40 does not address when a cost and the related liability (or other credit) should be recognized but does address whether a cost should be capitalized or expensed once the related liability is recognized. For example, ASC 340-40 does not address when a liability for commissions subject to clawback should be recognized. However, when that liability is recognized in accordance with other guidance, such as ASC 405, ASC 340-40 is applied to determine whether the corresponding costs should be capitalized or expensed.

13Q.2 May ASC 340-40 be applied to a portfolio of contracts?

While not explicitly provided for in ASC 340-40, we believe ASC 340-40 may be applied to a portfolio of contracts under the same circumstances that ASC 606 may be applied to a portfolio of contracts (see Section 5.4.1). We believe this is appropriate based on a reference in paragraph 7(b) of TRG 57 to using the portfolio approach to account for the incremental costs of obtaining a contract. As such, ASC 340-40 may be applied to a portfolio of similar contracts if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts. If an entity elects this practical expedient, any estimates or judgments it makes in applying ASC 340-40 to the portfolio of contracts should reflect the portfolio's size and composition. In addition, the entity should have support for why accounting for a portfolio of contracts is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts.



Spotlight on change

Capitalization of fulfillment costs and customer acquisition costs for which there is no specific guidance in legacy GAAP generally depended on whether those costs meet the definition of an asset and whether the entity made an accounting policy election to capitalize such costs. In other words, an entity generally was not required to capitalize such costs under legacy GAAP. Under ASC 340-40, an entity may be required to capitalize these costs depending on the facts and circumstances. This could result in a significant change if the entity does not already have an accounting policy that results in the capitalization of these costs.

The revenue recognition guidance in legacy GAAP for construction-type and production-type contracts (ASC 605-35) provided guidance on how entities within its scope should account for contract costs, which is different from the guidance in ASC 340-40. In addition, when an entity within the scope of ASC 605-35 used the percentage-of-completion method to recognize revenue, it was able to apply an approach under which revenue and contract costs were recognized based on the percentage complete, which could have resulted in the deferral of certain contract costs. This approach is not appropriate under either ASC 606 or ASC 340-40. Contract costs are only capitalized under ASC 340-40 if certain criteria are met. For these reasons and others, entities that apply ASC 605-35 could experience potentially significant changes in how they recognize contract costs.

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13.1 Costs to fulfill a contract

13.1.1 Scope

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are listed in the following table:

ASC	Type of fulfillment cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts (see Section 13.1.1.1)
350-40	Costs of internal-use software
360	Costs related to property, plant and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds
985-20	Costs of software to be sold, leased or marketed

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and (or) the specific cost being evaluated.

If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance.

13.1.1.1 NE&P costs related to long-term supply contracts

It is not uncommon for an entity to undertake NE&P activities for a customer, often in connection with fulfilling a long-term supply contract or in anticipation of entering into such a contract. Whether revenue should be recognized related to those activities (and, if so, how that revenue should be recognized) is discussed in detail in Section 6.8. With respect to accounting for the costs of NE&P activities, ASC 340-10 provides guidance on how to account for preproduction costs related to long-term supply arrangements, which include: (a) the costs to design and develop the products that will be sold under a long-term supply arrangement and (b) the costs to design and develop molds, dies and other tools that will be used in manufacturing the products that will be sold under the long-term supply arrangement.

Entities that have historically applied the preproduction costs guidance in ASC 340-10 because they incurred costs within its scope should continue to apply that guidance. Entities that have historically applied the preproduction costs guidance in ASC 340-10 by analogy should carefully consider the scope provisions of both that guidance and ASC 340-40, as well as how those scope provisions should be applied to its facts and circumstances. In doing so, reference should be made to Question 66 of the FASB RRI Q&As, which provides a summary of how the preproduction costs guidance in ASC 340-10 interacts with ASC 340-40. Entities that have historically applied the preproduction costs guidance in ASC 340-10 by analogy also should consider whether any changes to their accounting policy disclosures are warranted.

In addition, it is worth noting that if the entity concludes that NE&P activities do not generate revenue that should be accounted for under ASC 606, the related costs cannot be within the scope of ASC 340-40.

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13.1.2 Initial accounting

Costs to fulfill a contract for which there is no other applicable guidance should be capitalized when all of the following criteria are met:

- The costs incurred by the entity are directly related to a specific contract or specific anticipated contract (see Section 13.1.2.1).
- The costs incurred by the entity generate or enhance resources that will be used in the *future* to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not performance obligations in and of themselves but do contribute to the satisfaction of performance obligations). Fulfillment costs incurred to *presently* satisfy a performance obligation should not be capitalized. To better understand the type of fulfillment costs that should be capitalized if all of these criteria are met vs. the type of fulfillment costs that should not be capitalized because they do not meet this criterion, consider the fulfillment costs incurred in Example 13-3. The costs associated with the design, migration and testing of the data center are fulfillment costs that should be capitalized if all the criteria are met because they are generating or enhancing resources that will be used in the future to provide the service of managing the customer's IT data center. In contrast, the cost of the two employees that are primarily responsible for providing the service of managing the customer's IT data center (after the design, migration and testing of the data center are complete) are fulfillment costs that should not be capitalized because they are incurred to presently satisfy the performance obligation related to providing the service to the customer.
- The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the contract and expected renewals will cover the costs).

If these fulfillment cost capitalization criteria are met, the fulfillment costs must be capitalized.

13Q.1.2.1 Does a practical expedient exist with respect to not capitalizing fulfillment costs if the period over which they would otherwise be amortized is one year or less?

No. Unlike the guidance related to capitalizing incremental costs incurred to obtain a contract (see Section 13.2.1), there is no practical expedient that allows an entity to not capitalize fulfillment costs that should otherwise be capitalized.

13Q.1.2.2 How does an entity account for the costs incurred within the scope of ASC 340-40 to transfer goods or services to a customer when it has not yet entered into a contract with the customer that meets the contract existence criteria?

During the timeframe the entity transfers goods or services to a customer for which it is not able to recognize revenue because it has not yet entered into a contract with the customer that meets the contract existence criteria (see Section 5.2), the question arises with respect to how the entity should account for the fulfillment costs it incurs to transfer those goods or services when those fulfillment costs do not fall within the scope of other specific guidance in the ASC. This issue was addressed in Question 76 of the FASB RRI Q&As, and the FASB staff and TRG concluded that if the fulfillment costs an entity incurs to transfer goods or services to a customer before it has entered into a contract with the customer that meets the contract existence criteria do not fall within the scope of other specific guidance in the ASC but do meet the fulfillment cost capitalization criteria in ASC 340-40, such costs should be capitalized.

The FASB staff and TRG also discussed how any capitalized fulfillment costs should be recognized once a contract that meets the contract existence criteria is entered into with the customer. The FASB staff and TRG concluded that any capitalized fulfillment costs related to services transferred to a customer when the entity did not have a contract with the customer that met the contract existence criteria should be expensed if they relate to either progress made to date or services already transferred to the customer.

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Additional discussion is provided in Question 5Q.1.2 related to recognizing revenue when the entity has not yet entered into a contract with the customer that meets the contract existence criteria. In addition, Example 5-2 provides a detailed illustration of how to account for both revenue and fulfillment costs when the entity has not yet entered into a contract with the customer that meets the contract existence criteria, but subsequently does enter into such a contract.

13.1.2.1 Direct costs

The following table includes one list of costs that are considered directly related to a specific contract or anticipated contract and another list of costs that are not considered directly related to a specific contract or anticipated contract:

Are these costs considered directly related to a specific contract or anticipated contract?	
Yes	**No**
From ASC 340-40-25-7: 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).	From ASC 340-40-25-8: 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).

13.2 Costs to obtain a contract

13.2.1 Incremental costs to obtain a contract

13.2.1.1 Scope

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. However, consideration payable to the customer should not be considered an incremental cost to obtain a contract because specific guidance is provided in ASC 606 on that topic (see Section 7.5).

The FASB staff and TRG discussed various practice issues that have arisen with respect to whether certain costs should be considered incremental costs to obtain a contract. These issue were addressed in Question 78 of the FASB RRI Q&As, and the FASB staff and TRG suggested an entity consider the following when determining whether a cost is an incremental cost to obtain a contract: “Would the entity incur the cost if the customer (or the entity) decided, just as the parties are about to sign the contract, that it will not enter into the contract? If the costs would have been incurred even though the contract was not executed, then they are not incremental costs of obtaining a contract.” The entity must be obligated to make a payment only as a result of entering into the contract for the related cost to be considered an

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incremental cost of obtaining the contract. The following example includes various scenarios from Question 78 that involve different types of employee compensation (e.g., bonuses, commissions) and indicates whether the compensation would be considered an incremental cost to obtain a contract.



Example 13-1: Determining whether a cost is an incremental cost to obtain a contract

Scenario	Is the cost an incremental cost to obtain a contract?
From Example 1 of Question 78 of the FASB RRI Q&As: 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 affected by the current year's actual signed contracts.	No. The employee is entitled to a fixed salary, regardless of how many contracts he or she obtains for the entity.
From Example 2 of Question 78 of the FASB RRI Q&As: 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.	Sales commission: Yes, it is an incremental cost to obtain a contract because it would not have been incurred if the customer decided not to enter into the contract with the entity. Legal and travel costs: No, they are not incremental costs to obtain a contract. While the entity would not have obtained the contract without incurring these costs, the costs would have been incurred even if the customer decided not to enter into the contract with the entity.
From Example 3 of Question 78 of the FASB RRI Q&As: 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.	Yes, the entire sales commission should be considered an incremental cost to obtain a contract because the entity would not be obligated to pay the commission if the customer did not enter into the contract with the entity. The timing related to when the commission is actually paid has no bearing on whether the commission is an incremental cost to obtain a contract.

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From Example 4 of Question 78 of the FASB RRI Q&As: 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.	Yes, all three commissions would represent incremental costs to obtain a contract when a contract is obtained. The fact that commissions are paid at three different levels within an organization does not affect the determination as to whether the commissions represent incremental costs to obtain a contract. The key fact is that the commission is only paid to each level within the organization when a contract is obtained.
From Question 78 of the FASB RRI Q&As: An employee receives a discretionary annual bonus based on the entity (or a business unit within the entity) achieving sales growth targets, minimum profitability levels, and progress toward various strategic goals.	No, the annual bonus is not an incremental cost to obtain a contract because sales are only one of several components used in calculating the bonus, and the amount of the bonus ultimately is discretionary. The entity in this situation should consider whether the annual bonus would not be paid if a customer decided not to enter into a contract with the entity. Because the annual bonus would still be paid if a customer decided not to enter into a contract with the entity, it does not represent an incremental cost to obtain a contract.
From Example 5 of Question 78 of the FASB RRI Q&As: 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+	Yes, when a liability for commissions payable under the program is recognized in accordance with other GAAP, the cost would represent an incremental cost to obtain a contract because the commission cost would not have been incurred if the customer had not entered into a contract with the entity.

These scenarios and conclusions illustrate the importance of understanding and carefully considering the circumstances under which the entity must pay the employee compensation.

13Q.2.1.1.1 If a commission is paid to a salesperson upon a customer renewing its contract with the entity, is that commission considered an incremental cost to obtain a contract?

Yes. The entity would not have had to pay the commission if the customer had not renewed its contract with the entity. The amortization period for capitalized costs when there are contract renewals is discussed in Section 13.3.1.

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13Q.2.1.1.2 If a commission paid to a salesperson must be repaid to the entity or clawed back if the customer does not perform, can that commission be considered an incremental cost to obtain a contract?

Yes. The FASB staff and TRG addressed this issue in Question 68 of the FASB RRI Q&As. Since the related contract must have already qualified to be in the scope of the revenue guidance if an evaluation is being performed to determine whether these commissions are incremental costs to obtain a contract, that means that the entity must have concluded that the customer is committed to perform under the contract and collection is probable per ASC 606-10-25-1(a) and (e). Thus, the fact that the commission may be clawed back due to customer nonperformance is not relevant in determining whether the commission is an incremental cost to obtain a contract. An evaluation should be performed of this commission (similar to other commissions that may not be clawed back) to determine whether it qualifies for capitalization as discussed in Section 13.2.1.2.

13Q.2.1.1.3 Can fringe benefits on sales commissions paid be considered an incremental cost to obtain a contract?

Yes. The FASB staff and TRG addressed this issue in Question 74 of the FASB RRI Q&As. Fringe benefits incurred that directly resulted from commissions that qualify as incremental costs to obtain a contract should also be considered incremental costs to obtain a contract. This is appropriate as these fringe benefits would not have been incurred if the related contract was not obtained. Examples of fringe benefits relating to commissions including payroll taxes and matching 401k contributions. Note however that fringe benefits, such as health insurance premiums, generally would have been incurred regardless of whether the contract was obtained and, as a result, would not be considered incremental costs to obtain a contract.

13Q.2.1.1.4 Should an entity derecognize capitalized commissions when a modification of a contract is accounted for as if it were the termination of an existing contract and the creation of a new contract?

No. Because the contract was not actually terminated (instead it was accounted for as if it were terminated), we believe that the asset recognized for capitalized commissions (i.e., the incremental costs to obtain a contract) at the time of the modification should not be written off as long as those capitalized costs are related to the remaining goods or services to be provided after the contract modification. Judgment will be required to determine whether and to which of the remaining goods or services the asset is related. If the asset remains capitalized subsequent to the modification, it should continue to be evaluated for impairment in accordance with ASC 340-40 (see Section 13.4) and amortized over an appropriate period consistent with the transfer of the related goods or services (see Section 13.3).

13.2.1.2 Initial accounting

The incremental costs to obtain a contract should be capitalized if the entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less. As discussed in Section 13.3.1, when the capitalized costs relate to goods or services expected to be transferred under both the initial contract and one or more expected contract renewal(s), the expected contract renewals are reflected in the amortization period.

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Example 13-2: Accounting for various costs incurred to obtain a contract (ASC 340-40-55-2 to 55-4)

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$50,000

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.

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.



RSM COMMENTARY: As discussed in Section 13.2.2, if the external legal fees and travel costs were explicitly chargeable to the customer regardless of whether the entity entered into a contract with the customer for consulting services, those costs would be capitalized.

Example 13-3 illustrates the considerations involved in amortizing capitalized incremental costs to obtain a contract.

13.2.2 Costs to obtain a contract that are not incremental

The costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

We believe the subsequent accounting for costs to obtain a contract that were not incremental, but were capitalized because they were explicitly chargeable to the customer regardless of whether the entity and customer entered into a contract, depends on whether the entity and the customer enter into a contract:

- If the entity and customer enter into a contract, the capitalized costs should be treated the same as any other costs capitalized in accordance with ASC 340-40 (e.g., amortized over the appropriate period). The reimbursement from the customer should be included in the transaction price (see Section 7.3.7).

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- If the entity and customer do not enter into a contract, the capitalized costs should be derecognized when the customer reimburses the entity for the costs.

13.3 Amortization of capitalized costs

The amortization method and period used to amortize capitalized costs related to obtaining or fulfilling a contract (including an anticipated contract, such as a contract renewal) should be systematic and consistent with how and when the related goods or services are transferred to the customer. For example, if the capitalized costs relate to a service that is transferred to the customer continuously and evenly over the contract term, then straight-line amortization of those costs over the contract term would typically be appropriate. The effect of contract renewals on the amortization period is discussed in Section 13.3.1.

To the extent there is a significant change in how and when the related goods or services are transferred to the customer, the entity should make a corresponding change to the amortization method and (or) period used to amortize any related capitalized costs. The entity should treat this change as a change in accounting estimate under ASC 250. Consider the example in which the capitalized costs relate to a service that is expected to be transferred to the customer continuously and evenly over the contract term, which resulted in the straight-line amortization of those costs over the contract term. If how and when the service is provided changes significantly halfway through the contract term, such that the entity expects to transfer significantly more service to the customer in some parts of the remaining contract term compared to the other parts of the remaining contract term, the entity should make a corresponding change to both the timing of revenue recognition and the amortization method used to amortize the related capitalized costs. The change would result in the entity no longer recognizing revenue or amortizing the costs on a straight-line basis, and instead recognizing more revenue and amortizing more costs during those parts of the contract term the entity expects to transfer significantly more services to the customer and recognizing less revenue and amortizing less costs during those parts of the contract term the entity expects to transfer significantly fewer services to the customer. The entity should treat the change in the timing of revenue recognition and the amortization method as changes in estimates.

13Q.3.1 How should costs to obtain a contract be capitalized and amortized when a commission is paid only upon a specific threshold being met (that is, the commission is tiered)?

The FASB staff and TRG discussed the timing of capitalization and amortization in these situations as noted in Question 69 of the FASB RRI Q&As and determined that either of two approaches would be acceptable as long as they are applied consistently. To illustrate these approaches, consider an example in which upon a cumulative threshold of contracts being entered into (6 contracts), a commission is paid on that contract as a percentage of the cumulative value of that contract plus all preceding contracts (1–5). The following two approaches for capitalization and amortization were determined to meet the objective of amortizing costs on a basis that is consistent with the transfer to the customer of related goods or services:

- Approach 1: Capitalize the total commission costs (commission percentage multiplied by the cumulative value of contracts 1–6) to the contract that resulted in the criteria being met (contract 6). Amortize the recognized commission costs over the expected customer relationship term of that contract.
- Approach 2: Upon the threshold being met, capitalize the total expected commission costs to be earned to each contract (contracts 1–6) ratably as each contract is signed. Amortize the recognized commission costs over the expected customer relationship term for each of the contracts.

The FASB staff and TRG explained that Approach 1 may result in a counterintuitive answer if the commission paid upon entering into the contract that resulted in the threshold being met (contract 6 in this example) is large in relation to the contract price of that contract. However, they still consider Approach 1 to be an acceptable approach in these situations.

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13Q.3.2 If there are multiple performance obligations in a contract, is an entity required to allocate any capitalized contract costs to the different performance obligations to determine the amortization period?

No. While an entity is not precluded from allocating capitalized contract costs to the related individual performance obligations in a contract, it is not required to do so for purposes of determining the appropriate period of amortization. ASC 340-40-35-1 requires entities to amortize capitalized costs in a manner consistent with how and when the related goods or services are transferred to the customer. The FASB staff and TRG discussed in Question 75 of the FASB RRI Q&As how an entity could meet the requirements in ASC 340-40-35-1 without directly allocating the capitalized contract costs to the individual performance obligations in situations in which there are multiple performance obligations in a contract and their pattern of transfer differs.

The following two approaches were determined to be acceptable in these situations:

- Approach 1: Allocate the asset to the individual performance obligations in proportion to the transaction price allocated to each performance obligation (or on another relative basis), and amortize the allocated portion of the asset based on the pattern of transfer of the performance obligation it was allocated to.
- Approach 2: Amortize the asset using one pattern of transfer that best reflects the "use" of the asset as the goods and services in the contract are transferred. In determining this amortization pattern and period, an entity should consider all the performance obligations in the contract.

The different approaches may result in a similar pattern and period of amortization, but Approach 2 would not result in any allocation of the asset to the individual performance obligations. If an entity uses Approach 2, we do not believe the entity has to perform the allocation in Approach 1 to verify that the amortization period determined in Approach 2 is similar. We also believe that entities should apply the chosen approach consistently to similar contractual arrangements.

13.3.1 Effect of contract renewals on the amortization period

Determining whether it is appropriate to include contract renewals (i.e., specified anticipated contract[s]) in the amortization period for capitalized costs depends on whether the costs relate to goods or services expected to be transferred under: (a) only the initial contract or (b) both the initial contract and one or more expected contract renewal(s). When the capitalized costs relate to goods or services expected to be transferred under both the initial contract and one or more expected contract renewal(s), the expected contract renewals are reflected in the amortization period.

In determining whether the capitalized costs relate to goods or services transferred under only the initial contract or both the initial contract and one or more expected contract renewal(s), an entity should consider the nature of the costs and whether similar costs will be incurred more than once. For example, capitalized setup costs that will only be incurred upfront, but will facilitate the entity transferring goods or services to the customer for as long as the customer remains a customer of the entity, relate to both the initial contract and any expected contract renewals. Likewise, when a commission is only paid upon the entity initially obtaining the contract (i.e., no commission is paid upon contract renewals), the capitalized commission cost relates to both the initial contract and any expected contract renewals. Conversely, when commissions are paid upon the entity obtaining the contract and upon obtaining contract renewals, the capitalized commission cost may only relate to the initial contract. Paragraph BC309 of ASU 2014-09 indicates the following:

> …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.

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The FASB staff and TRG discussed what it means for a commission paid on a contract renewal to be commensurate with the commission paid on contract initiation. This issue is addressed in Question 72 of the FASB RRI Q&As, and the FASB staff and TRG indicated that a commission paid for obtaining a contract renewal is commensurate with a commission paid for obtaining the initial contract if both are "reasonably proportional to the respective contract value." While this often will mean that the renewal commission percentage or rate should be the same as the initial commission percentage or rate for the renewal commission to be considered commensurate with the initial commission, this does not always have to be the case. While the FASB staff and TRG confirmed this in Question 72, they also clarified that the level of effort put forth in obtaining the contract renewal compared to obtaining the initial contract should not be considered in determining whether the contract renewal commission is commensurate with the initial contract commission. For example, if the initial contract value and renewed contract value are the same, but the entity pays a lower commission for the contract renewal because obtaining the contract renewal requires less effort than obtaining the initial contract, the initial commission and renewal commission are not commensurate. The key is for each commission to be reasonably proportional to the respective contract value, not the respective level of effort put forth to initially obtain or renew the contract.

When there are contract renewals, determining the amortization period will require the entity to carefully consider its facts and circumstances and may require the entity to exercise significant judgment.



Example 13-3: Capitalizing and amortizing both fulfillment costs and incremental costs to obtain a contract (ASC 340-40-55-5 to 55-9)

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.

Costs to Fulfill a Contract

The initial costs incurred to set up the technology platform are as follows:

Design services	$40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	100,000
Total costs	$350,000

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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.

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.



RSM COMMENTARY: While the average customer term was the appropriate amortization period to use in this example, this may not be the case in other situations, as discussed in Question 13Q.3.1.1.

As discussed earlier, if the entity in this example paid a commission to obtain the contract renewal and that commission was commensurate with the commission paid to obtain the initial contract, the amortization period for the capitalized commission cost would have been limited to five years. The amortization period for the capitalized fulfillment costs would still be seven years because no additional fulfillment costs are expected to be incurred related to the renewal periods.

13Q.3.1.1 Should an entity use the average customer term (i.e., life) as the period over which to amortize capitalized costs?

The FASB staff and TRG discussed when an entity should use the average customer life as the amortization period for costs capitalized in accordance with ASC 340-40. This issue is addressed in Question 79 of the FASB RRI Q&As, and the FASB staff and TRG concluded that the average customer life should be used as the amortization period for capitalized costs when the costs relate to goods or services expected to be transferred to the customer over the average customer life. As discussed earlier, making this determination should consider the nature of the costs and whether similar costs will be incurred more than once. In addition, the FASB staff and TRG point out that the average customer life calculated based on historical information may not be relevant to what the average customer life will be for new customers. This may be particularly true when the entity has historically experienced longer average customer lives. For example, if an entity determines that its average customer life is 20 years, the circumstances that gave rise to that average over the last 20 years may be different than the circumstances a new customer will encounter. As a result, even if the capitalized costs relate to goods or services expected to be transferred to the customer over its life, the entity needs to consider whether the average customer life of past customers is representative of the average customer life of new customers.

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13Q.3.1.2 Should the contract term used for purposes of recognizing revenue under ASC 606 be used for purposes of amortizing capitalized costs under ASC 340-40?

Not necessarily. The basis for determining the contract term over which to recognize revenue under ASC 606 (see Section 5.3) is different from the basis for determining the period over which to amortize any related capitalized costs under ASC 340-40.

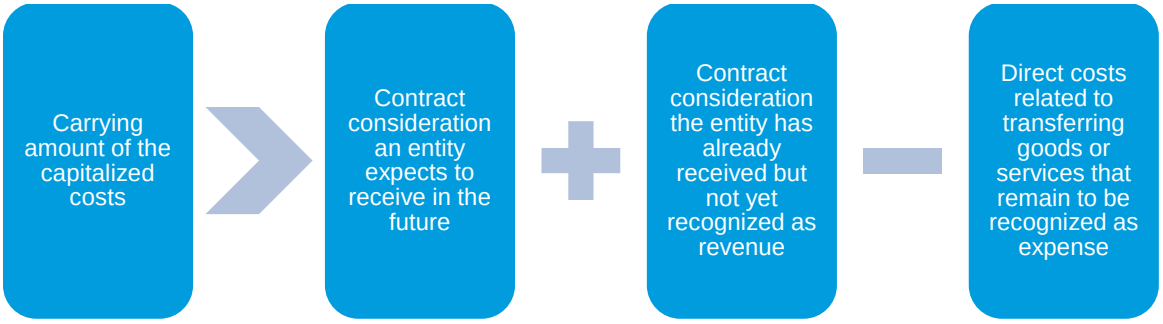
13Q.3.1.3 How should capitalized costs be amortized when the commission paid on contract renewal is not commensurate with the commission paid on contract initiation?

The FASB staff and TRG discussed the timing of amortization in these situations as noted in Question 71 of the FASB RRI Q&As and determined that either of two approaches would be acceptable as long as they are applied consistently. To illustrate these approaches, assume a salesperson is paid a $100 commission on a new customer contract and a $60 commission on renewal of that contract. Also assume the $60 commission on renewal is not commensurate with the $100 commission paid at contract inception. Both the initial commission and renewal commission were capitalizable. The two approaches for amortization that were determined to be acceptable in this fact pattern were as follows:

- Approach 1 - The initial capitalized commission ($100) should be amortized over the period that includes all specific anticipated contract renewals. The renewal commission ($60) should be amortized over that renewal period.
- Approach 2 – The initial capitalized commission ($100) should be separated into a component that's commensurate with the renewal commission ($60) and the remaining component ($40). The commensurate portion of the commission ($60) should be amortized over the original contract term with the remaining $40 amortized over the period that includes all specific anticipated contract renewals. The renewal commission ($60) should be amortized over that renewal period.

13.4 Impairment

Costs capitalized in accordance with ASC 340-40 are tested for impairment by comparing the carrying amount of the capitalized costs to an amount that considers all of the following: (a) the contract consideration an entity expects to receive in the future, (b) the contract consideration the entity has already received but not yet recognized as revenue and (c) the direct costs related to transferring goods or services that remain to be recognized as an expense under the contract. An impairment loss is recognized when:



For purposes of testing the capitalized costs for impairment, the time period reflected in the impairment test should take into consideration expected contract renewals and extensions with the same customer. In addition, contract consideration is the transaction price otherwise determined under ASC 606 reduced by the amount the entity does not expect to collect from the customer due to its credit risk (see Section 5.2.1 for discussion of how credit risk is addressed in ASC 606) and increased to remove the effects of the variable consideration constraint (if any) (see Section 7.3.3).

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Before recognizing an impairment loss on costs capitalized in accordance with ASC 340-40, an entity should first evaluate whether any impairment losses exist on certain other assets related to its contracts, such as inventory or capitalized costs of software to be sold or leased. In addition, an entity should recognize any necessary impairment loss on costs capitalized in accordance with ASC 340-40 before it tests and recognizes an impairment loss on other assets within the scope of ASC 340 (e.g., preproduction costs capitalized in accordance with the applicable guidance in ASC 340-10), ASC 360 (e.g., property, plant and equipment) or ASC 350 (e.g., goodwill).

Once an impairment loss is recognized, it is not reversed under any circumstances.

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14. Presentation

Application of the guidance in ASC 606 may result in the recognition and presentation on the balance sheet of a contract asset or liability for the difference between the entity's performance (i.e., the goods or services transferred to the customer) and the customer's performance (i.e., the consideration paid by, and unconditionally due from, the customer). However, before recognizing a contract asset or liability, the entity must first consider whether an accounts receivable should be recognized.

Many of the questions that follow are based on issues related to contract assets and liabilities discussed by the FASB staff and TRG. These issues are addressed in Questions 61 through 63 of the FASB RRI Q&As.

14Q.1 Can a contract asset or liability exist if neither the entity nor the customer has performed?

No. For a contract asset or liability to exist, at least one of the parties to the contract must have performed under the contract.

14Q.2 Are contract assets and liabilities determined at the contract level or the performance obligation level?

The FASB staff and TRG concluded that the contract assets and liabilities should be determined at the contract level.

14Q.3 When contracts are combined for purposes of applying ASC 606, is the need for a contract asset or liability determined at the individual contract level or the combined contract level?

The FASB staff and TRG discussed situations in which two or more contracts are combined for purposes of applying ASC 606 because they meet the contract combination criteria (see Section 5.4), and whether the need for a contract asset or liability in these situations is determined at the individual contract level or the combined contract level. The FASB staff and TRG concluded that the need for a contract asset or liability in such situations should be determined at the combined contract level.

14Q.4 Could a situation arise in which an entity recognizes both a contract asset and a contract liability for the same contract (or combined contract)?

The FASB staff and TRG concluded that at any given point in time there should only be either a contract asset or a contract liability that results from the application of ASC 606 to a particular contract (or combined contract). In other words, accounting for one contract (or combined contract) under ASC 606 should not result in there being both a contract asset and a contract liability recognized for the contract at the same time. However, in accounting for a contract (or combined contract) over time, it is possible for a contract asset (or liability) to result from the initial accounting for that contract and for that contract asset (or liability) to flip to a contract liability (or asset) later in the contract term due to changes in the facts and circumstances. For example, early in the contract term the entity may have performed more than the customer (which results in a contract asset), but later in the contract term the entity may have performed less than the customer (which results in a contract liability).

14Q.5 Can other assets or liabilities be offset against contract assets and liabilities?

When accounting for a contract (or combined contract), ASC 606 is clear that any accounts receivable recognized in connection with that contract should be recognized separately from any contract asset or liability recognized for that contract.

The FASB staff and TRG discussed whether other assets or liabilities can be offset against contract assets and liabilities. For example, if an entity has a contract liability related to one contract and an accounts receivable related to another contract with the same customer, can they be offset against each other? The FASB staff and TRG concluded that this question is not addressed in ASC 606, and as a result, the guidance in ASC 210-20 should be used to determine whether the asset and liability in this

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situation can be offset against each other. Given the requirements in ASC 210-20-45, it seems unlikely that the right of set off would exist in many contracts such that a contract liability related to one contract and an accounts receivable related to another contract with the same customer could be offset.

14.1 Accounts receivable

When determining the amount of the contract asset or liability to be recognized (if any), an entity should first determine whether it has an unconditional right to any consideration from the customer. An unconditional right exists when only the passage of time is required before customer payment. If the entity has an unconditional right to consideration from the customer, it should recognize a receivable. This is the case even if the customer has a right of refund.

Accounts receivable should be accounted for under both ASC 310 and ASC 326-20. If there is a difference between the initial amount of accounts receivable to be recognized (as measured under ASC 310 and ASC 326-20) and the corresponding amount of revenue recognized in accordance with ASC 606, this difference should be recognized as credit loss expense and not a reduction of revenue.

For additional information about ASC 326 and the current expected credit losses model, refer to A Guide to Accounting for Investments, Loans and Other Receivables.

14Q.1.1 Should an accounts receivable be recognized when an entity invoices its customer?

Not necessarily. An accounts receivable should only be recognized when an entity invoices its customer if the entity has an unconditional right to the consideration being sought from the customer in the invoice. If the entity does not have an unconditional right to an amount for which the entity has invoiced the customer, the invoiced amount should not be recognized as an accounts receivable. Depending on the facts and circumstances, an unconditional right to consideration could exist before, after or at the point in time the entity invoices the customer because invoicing a customer is not what typically triggers the entity's unconditional right to consideration. Whether a contract asset should be recognized also does not depend on whether the entity has invoiced the customer (see Section 14.3). Consider the following discussion from paragraph BC325 of ASU 2014-09:

> In many cases, an unconditional right to consideration arises when the entity satisfies the performance obligation and invoices the customer. For example, a payment for goods or services is typically due and an invoice is issued when the entity has transferred the goods or services to the customer. However, the act of invoicing the customer for payment does not indicate whether the entity has an unconditional right to consideration. For instance, the entity may have an unconditional right to consideration before it invoices (unbilled receivable) if only the passage of time is required before payment of that consideration is due. In other cases, an entity can have an unconditional right to consideration before it has satisfied a performance obligation. For example, an entity may enter into a noncancellable contract that requires the customer to pay the consideration a month before the entity provides goods or services. In those cases, on the date when payment is due, the entity has an unconditional right to consideration. (However, in those cases, the entity should recognize revenue only after it transfers the goods or services.)

14.2 Contract liability

A contract liability arises if the customer's performance is greater than that of the entity (i.e., the consideration paid plus any amount recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer). The contract liability is recognized upon the earlier of the customer making a payment or becoming unconditionally obligated to make a payment that results in the customer's performance being greater than the entity's performance. The recognition of a contract liability signals to users of the financial statements that the entity's customer has paid for, or is unconditionally obligated to pay for, promised goods or services the entity is obligated to transfer to the customer, but has not yet transferred to the customer.

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Typically, a refund liability to the customer (which may arise, for example, when the customer has a right of return [see Section 7.3.6]) is not considered a contract liability and should not be included with the contract liability for presentation purposes. A contract liability is defined in ASC 606 as an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer. A refund liability generally doesn't meet this definition as it typically obligates an entity to return consideration to a customer (under certain conditions) rather than to transfer goods or services to a customer.

Contract liability is not the prescribed descriptor for the related liability in the balance sheet. In other words, another descriptor may be used.

In addition to the three examples at the end of this chapter, there are numerous examples in other chapters in which a contract liability is recognized, including Example 6-16, Example 6-31, Example 7-3, Example 7-26, Example 8-6, Example 9-10 and Example 9-13.

14.3 Contract asset

A contract asset arises if the entity's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is greater than the consideration paid plus any amount recognized as a receivable). The recognition of a contract asset signals to users of the financial statements that the entity has transferred promised goods or services to the customer (and recognized revenue) for which the customer has neither paid nor become unconditionally obligated to pay. In other words, a contract asset represents the entity's conditional right to consideration for its performance.

Contract costs recorded as assets as discussed in Chapter 13 are not considered contract assets and should not be included with the contract asset for presentation purposes. A contract asset is defined in ASC 606 as 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). A contract cost asset doesn't meet this definition as it represents a deferred cost from obtaining or fulfilling a contract rather than a conditional right to future consideration from a customer.

Contract asset is not the prescribed descriptor for the related asset in the balance sheet. In other words, another descriptor may be used. However, if a descriptor other than *contract asset* is used, it needs to clearly indicate that the asset represents something other than a receivable.

Once recognized, a contract asset is evaluated for impairment (or credit losses) in accordance with ASC 310 and ASC 326-20, which also is used to measure, present and disclose any impairment (or credit) loss resulting from the evaluation.

In addition to the three examples that follow, there are numerous examples in other chapters in which a contract asset is recognized, including Example 7-5 and Example 8-9.

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Example 14-1: Determining whether a contract liability and a receivable should be recognized for cancellable and noncancellable contracts (606-10-55-284 to 55-286)

Case A—Cancellable Contract

On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. The entity receives cash of $1,000 on March 1, 20X9 (cash is received in advance of performance).

Cash	$1,000	
Contract liability		$1,000

b. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$1,000	
Revenue		$1,000

Case B—Noncancellable Contract

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.

Receivable	$1,000	
Contract liability		$1,000

b. The entity receives the cash on March 1, 20X9.

Cash	$1,000	
Receivable		$1,000

c. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$1,000	
Revenue		$1,000

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).

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Example 14-2: Recognition of a contract asset when the entity has performed and the customer's payment is conditional on delivery (ASC 606-10-55-287 to 55-290)

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.

Contract asset	$400	
Revenue		$400

The entity satisfies the performance obligation to transfer Product B and to recognize the unconditional right to consideration.

Receivable	$1,000	
Contract asset		$400
Revenue		$600



Example 14-3: Recognition of a contract asset and a refund liability (ASC 606-10-55-291 to 55-294)

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.

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).

In determining the transaction price, the entity concludes at contract inception that the customer will meet the 1 million products threshold and therefore estimates that the transaction price is $125 per product. Consequently, upon the first shipment to the customer of 100 products the entity recognizes the following.

Receivable	$15,000 [a]	
Revenue		$12,500 [b]
Refund liability		$2,500 [b]

(a) $150 per product × 100 products

(b) $125 transaction price per product × 100 products

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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).

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15. Disclosure

There are both qualitative and quantitative disclosure requirements included in ASC 606-10-50 and ASC 340-40-50. While there are additional disclosures required for public entities, disclosures are still quite extensive for nonpublic entities (see Appendix C and Appendix D).

15.1 Disclosure objective and overall disclosure considerations for ASC 606 and ASC 340-40

ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40):

> 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.

The disclosures required to achieve this objective fall into three primary categories:

- *Contracts*. An entity should disclose information about its contracts, including: (a) certain overall revenue-related amounts (see Section 15.2.1), (b) disaggregated revenue (see Section 15.2.2), (c) contract balances (see Section 15.2.3), (d) performance obligations (see Section 15.2.4) and (e) the transaction price allocated to remaining performance obligations (see Section 15.2.5).
- *Significant judgments.* An entity should disclose those judgments (and the changes to those judgments) it makes in applying ASC 606 that have a significant effect on when and how much revenue is recognized related to its contracts, including those judgments (and changes in judgments) involved in: (a) determining when its performance obligations are satisfied (see Section 15.2.6) and (b) determining the transaction price and allocating it to the performance obligations (see Section 15.2.7).
- *Capitalized costs*. An entity should disclose specific information related to the fulfillment costs and incremental costs to obtain contracts that it capitalized in accordance with ASC 340-40 (see Section 15.3).

In addition, disclosures related to practical expedients are required (see Section 15.2.8).

15Q.1.1 What level of detail or disaggregation is required of an entity in complying with the specific disclosure requirements in ASC 606 and ASC 340-40?

In some cases, the level of detail or disaggregation required will be apparent within the specific disclosure requirement. In other cases, the level of detail required is the level of detail needed to achieve the overall disclosure objective of ASC 606. In addition, ASC 606-10-50-2 indicates the following with respect to the level of disaggregation required: “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.”

15Q.1.2 For which periods or period ends do the specific disclosure requirements apply?

If the disclosure relates to an income statement item (e.g., revenue recognized under ASC 606), the required information should be disclosed for all periods reflecting application of ASC 606 and ASC 340-40 that are included in the income statement. If the disclosure relates to a balance sheet item (e.g., contract assets and liabilities), the required information should be disclosed for each balance sheet presented that reflects the application of ASC 606 and ASC 340-40.

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15Q.1.3 If other guidance in the ASC requires disclosure of the same information as required by ASC 606 or ASC 340-40, should the entity repeat the information in its ASC 606 or ASC 340-40 disclosures?

No. If the entity discloses information to comply with requirements in other guidance in the ASC and that information also satisfies a disclosure requirement in ASC 606 or ASC 340-40, the entity need not repeat the information in its ASC 606 or ASC 340-40 disclosures.

15Q.1.4 Are the disclosures in ASC 606 and ASC 340-40 required only for annual financial statements or both annual and interim financial statements?

ASC 606 and ASC 340-40 require both annual and interim disclosures, but the interim disclosures are only required of public entities. When an entity applies ASC 606 and ASC 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and ASC 340-40 in its annual financial statements, the entity must provide all the required annual disclosures in those interim financial statements. After the entity applies ASC 606 and ASC 340-40 in its annual financial statements for the first time (and provides all the required annual disclosures), only the required interim disclosures (if any) need to be included in its future interim financial statements, unless there has been a significant change in the information disclosed in its most recent annual financial statements.

The disclosures addressed in the remainder of this chapter are the required annual disclosures unless otherwise noted.

15.2 Disclosures required by ASC 606 and ASC 952-606

To satisfy the disclosure objective, the FASB requires entities to disclose specific information. The checklist in Appendix C includes the disclosures required of public entities on both an interim and annual basis, while the checklist in Appendix D includes the minimum disclosures required of nonpublic entities.

15.2.1 Certain overall revenue-related amounts

15.2.1.1 Disclosures required for all entities

For all entities, the following amounts for the reporting period should either be separately presented on the face of the income statement or in the notes to the financial statements:

- *Revenue recognized from the entity's contracts*. This amount should not be included with revenue from other sources.
- *Impairment (or credit) losses on accounts receivable or contract assets related to the entity's contracts that were recognized in accordance with ASC 310 (or ASC 326-20)*. These amounts should not be included with impairment (or credit) losses on other contracts.

15.2.2 Disaggregated revenue

15.2.2.1 Disclosures required for public entities and elective for nonpublic entities

Quantitative disaggregation of revenue based on how economic factors affect the nature, amount, timing and uncertainty of revenue recognition and cash flows should be disclosed by public entities and may be disclosed by nonpublic entities. For those nonpublic entities that elect not to provide the disaggregation-of-revenue disclosures required of public entities, other information about disaggregated revenue must be disclosed (see Section 15.2.2.2).

Examples of the categories by which it may be appropriate for an entity to disaggregate revenue for disclosure include:

- The types of goods or services it provides
- The geographic regions of its operations

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- The types of customers it serves
- The types of markets it serves
- The types of contracts into which it enters
- The duration of its contracts
- The timing of when it transfers the goods or services to its customers
- The sales channels it uses

When determining the categories it should use for purposes of disaggregating its revenue in the footnotes to the financial statements, an entity should consider whether, and if so how, it has disaggregated revenue for other purposes (if any). To this end, ASC 606-10-55-90 indicates an entity should consider whether it has disaggregated revenue for any of the following other purposes:

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.

If an entity has disaggregated revenue for any of these purposes, it should consider the categories used and whether they also should be used for purposes of disaggregating revenue in the footnotes to the financial statements.

The number of categories by which an entity should disaggregate its revenue depends on the entity's facts and circumstances. As a result, the number of categories used likely will vary by entity, with some entities using more categories than other entities.

If an entity is required or elects to disclose revenue information for each reportable segment in accordance with ASC 280, it must also disclose information that facilitates users of the financial statements understanding the relationship between that revenue information and the disaggregated revenue information disclosed in accordance with ASC 606.

Public entities should provide the disaggregated revenue disclosures discussed in this section in their interim financial statements as well as their annual financial statements.



Example 15-1: Quantitative disclosure of disaggregated revenue (ASC 606-10-55-296 to 55-297)

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.

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The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation, and energy segments in accordance with paragraphs 606-10-50-6.

Segments	Consumer Products	Transportation	Energy	Total
Primary Geographical Markets				
North America	$990	$2,250	$5,250	$8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	$1,990	$3,260	$6,250	$11,500
Major Goods/Service Lines				
Office supplies	$600	-	-	$600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	$1,990	$3,260	$6,250	$11,500
Timing of Revenue Recognition				
Goods transferred at a point in time	$1,990	$3,260	$1,000	$6,250
Services transferred over time	-	-	5,250	5,250
	$1,990	$3,260	$6,250	$11,500

15.2.2.2 Disclosures required for nonpublic entities that do not elect to provide the disclosures required for public entities

Nonpublic entities that do not elect to provide the disaggregation-of-revenue disclosures required for public entities should disaggregate revenue based on when control of the goods or services transfers to the customer (e.g., over time or at a point in time). In addition, such nonpublic entities should provide qualitative discussion about how economic factors (such as those that might otherwise serve as the basis for quantitative disaggregation) affect the nature, amount, timing and uncertainty of revenue recognition and cash flows.

15.2.3 Contract balances

15.2.3.1 Disclosures required for all entities

The opening and closing balances of accounts receivable, contract assets and contract liabilities should be disclosed for all periods presented (if not already separately presented on the face of the balance

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sheet) by all entities. Although the required disclosure explains that it may be met through separately presenting these balances on the face of the balance sheet, the face of the balance sheet does not include the opening balances of the earliest period presented (comparative period). Therefore, entities should ensure that the opening balances of accounts receivable, contract assets and contract liabilities for the comparative period are disclosed elsewhere in the accompanying notes to the financial statements. Public entities should disclose or separately present these balances in their interim financial statements as well as their annual financial statements.

15.2.3.2 Additional disclosures required for public entities and elective for nonpublic entities

The following information should be disclosed by public entities and may be disclosed by nonpublic entities:

- *The amount of revenue recognized in the current reporting period that was included in the contract liability balance at the end of the previous reporting period.* For example, if an entity had a contract liability balance at the end of the previous reporting period due to it receiving upfront nonrefundable payments for which it had not yet fully performed, it should disclose the amount of that liability that was recognized as revenue in the current reporting period. Public entities should disclose this information in their interim financial statements as well.
- *An explanation (which may be qualitative) of the timing of the entity's satisfaction of its performance obligations compared to the timing of when it typically receives payment for providing the underlying goods or services and how the contract asset and contract liability balances are affected by this timing.* For example, when a construction contractor constructs buildings for its customers, it should disclose the timing of transferring control of the buildings to its customers as compared to the timing of when it receives payments from those customers and how this timing affects any related contract asset or contract liability balances.
- *A qualitative and quantitative explanation of what caused significant changes in the contract assets or contract liabilities during the reporting period*. ASC 606-10-50-10 lists the following as examples of what could cause a change in a contract asset or liability:
    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).

15.2.4 Performance obligations

15.2.4.1 Disclosures required for all entities

An entity is required to describe in its disclosures the following about its performance obligations:

- *When its performance obligations are typically satisfied.* In describing when its performance obligations are typically satisfied (e.g., upon delivery of the product because that is when control of the product transfers to the customer), if an entity enters into bill-and-hold arrangements, it is specifically required to describe when the performance obligations in such arrangements are satisfied.

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- *The significant payment terms for its contracts*. For example, an entity should disclose:
  - When payments are typically due from customers
  - Whether it enters into contracts with significant financing components
  - Whether it enters into contracts with variable consideration, and if so, whether application of the variable consideration constraint results in the amount of variable consideration included in the transaction price being constrained
- *The nature of the promised goods or services in its contracts*. When describing the nature of the promised goods or services in its contracts, the entity should highlight any situations in which it is acting as an agent and arranging for another party to transfer the promised goods or services to the customer.
- *The obligations it has in its contracts related to rights of return or refund or other similar customer rights.* For example, a retailer that provides customers with the right of return should describe the obligation it has to its customers related to that right.
- *The warranties and related obligations related to what it provides to its customers*. An entity should describe the types of warranties and related obligations it provides to its customers.

Additionally, for service-type warranties, entities should disclose the information required by ASC 460, which includes the nature of the warranties and any recourse provisions and whether there are assets held either as collateral or by third parties. They also should disclose the current carrying amount of the liability for the entity's obligations under the warranties for the reporting period, the accounting policy and methodology used in determining the liability, and a tabular reconciliation of the changes in the liability.

15.2.4.2 Disclosures required for public entities and elective for nonpublic entities

A public entity also is required to disclose the amount of revenue recognized in the current reporting period related to performance obligations satisfied (or partially satisfied) in the prior reporting period. For example, an entity should disclose the sales-based royalties it recognized in the current period related to a license of functional IP that was satisfied at a point in time in a prior period. Public entities should disclose this information in their interim financial statements as well as their annual financial statements.

15.2.5 Transaction price allocated to remaining performance obligations

Remaining performance obligations are those performance obligations identified in a contract entered into before the end of the reporting period for which control of some or all of the underlying goods or services has not been transferred to the customer at the end of the reporting period. A remaining performance obligation may be a partially satisfied performance obligation or a completely unsatisfied performance obligation.

15.2.5.1 Disclosures required for public entities and elective for nonpublic entities

With certain exceptions, the following information about an entity's remaining performance obligations at the end of the reporting period should be disclosed by public entities and may be disclosed by nonpublic entities:

- *The total amount of the transaction price allocated to those remaining performance obligations.* For example, a construction contractor may disclose the amount of transaction price allocated to the remaining performance obligations it has under its incomplete contracts at the end of the reporting period.
- *An explanation of when the entity expects to recognize the transaction price allocated to those performance obligations as revenue*. This disclosure can be satisfied either quantitatively (using

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appropriate time bands for when the allocated transaction price is expected to be recognized as revenue) or qualitatively. For example, a software company may disclose the time bands related to when it expects to recognize the transaction price allocated to the remaining performance obligations it has under its incomplete contracts at the end of the reporting period.

The following are two optional exemptions related to these remaining performance obligation disclosure requirements:

- The disclosures do not have to be provided if either of the following criteria are met:
  - The original expected duration of the contract to which the remaining performance obligation relates is one year or less.
  - The consideration is not fixed and the entity qualifies for and is using the practical expedient that allows it to recognize revenue for the amount it has a right to invoice (see Section 9.3.1.1).
- Information related to variable consideration does not have to be included in the disclosures if either of the following criteria are met:
  - The sales- and (or) usage-based royalty exception (see Section 7.3.5) applies to the variable consideration.
  - The variable consideration has been allocated in its entirety to either the wholly unsatisfied performance obligation to which it specifically relates, or the wholly unsatisfied distinct good or service in a single performance obligation resulting from the series exception to which it specifically relates (see Section 8.3.2 and Section 8.3.2.1).

To the extent the contract includes both fixed and variable consideration (e.g., sales-based royalty with a guaranteed minimum), these optional exemptions only apply to the variable consideration (e.g., the optional exemption would not apply to the guaranteed minimum sales-based royalty).

If one or more of the optional exemptions has been elected, a public entity should disclose which of the optional exemptions it has elected to apply, as well as the following information about the related remaining performance obligations: (a) their nature, (b) their remaining duration and (c) a description of any variable consideration excluded from the disclosures as a result of electing one or both of the optional exemptions. The entity should ensure that the information it discloses provides users of the financial statements with the information they need to understand the remaining performance obligations it excluded from the remaining performance obligation disclosure requirements under one or both of the optional exemptions.

In addition, public entities should and nonpublic entities may disclose whether there is any consideration not included in the transaction price (perhaps due to the variable consideration constraint), and therefore, not included in the remaining performance obligation disclosure requirements.

Public entities should disclose the information discussed in this section in their interim financial statements as well as their annual financial statements.



Example 15-2: Quantitative disclosure of transaction price allocated to remaining performance obligations (ASC 606-10-55-298 to 55-305A)

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.

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Contract A

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.

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

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.

The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The information for Contract B included in the overall disclosure is as follows.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$4,800 [a]	$2,400 [b]	$7,200

(a) $4,800 = $400 × 12 months

(b) $2,400 = $400 × 6 months

Contract C

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.

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	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$1,575 [a]	$788 [b]	$2,363

(a) Transaction price = $3,150 ($100 × 24 months + $750 variable consideration) recognized evenly over 24 months at $1,575 per year

(b) $1,575 ÷ 2 = $788 (that is, for 6 months of the year)

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 15-3: Qualitative disclosure of transaction price allocated to remaining performance obligations (ASC 606-10-55-306 to 55-307)

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.

At December 31, 20X2, the entity discloses the amount of the transaction price that has not yet been recognized as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognize that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

As of December 31, 20X2, the aggregate amount of the transaction price allocated to the remaining performance obligation is $6.8 million, and the entity will recognize this revenue as the building is completed, which is expected to occur over the next 12–18 months.

15.2.6 Significant judgments about the timing of satisfying performance obligations

15.2.6.1 Disclosures required for all entities

For performance obligations satisfied over time, all entities should disclose the specific input or output method used to recognize revenue over time.

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15.2.6.2 Additional disclosures required for public entities and elective for nonpublic entities

The following information should be disclosed by public entities and may be disclosed by nonpublic entities:

- For performance obligations satisfied over time, an explanation about why the specific input or output method used to recognize revenue over time provides a faithful depiction of how the entity transfers control of goods or services to its customers.
- For performance obligations satisfied at a point time, the significant judgments made in determining when control of the goods or services transfers to the customers.

15.2.7 Significant judgments about the transaction price and the amounts allocated to performance obligations

15.2.7.1 Disclosures required for all entities

The judgments involved in identifying the methods, inputs and assumptions used in the application of the variable consideration constraint should be disclosed by all entities.

15.2.7.2 Additional disclosures required for public entities and elective for nonpublic entities

The following information should be disclosed by public entities and may be disclosed by nonpublic entities:

- The judgments involved in identifying the methods, inputs and assumptions used to determine and allocate the transaction price and measure any obligations related to the contract (e.g., returns, refunds), including (but not limited to) the following:
  - If there is variable consideration, the entity should explain how it estimates the variable consideration (e.g., the most likely amount method or the expected value method).
  - If there is a significant financing component included in the contract, the entity should disclose how it was reflected in the transaction price.
  - If there is noncash consideration included in the contract, the entity should disclose how it was measured.
- For contracts that include more than one performance obligation, the judgments involved in identifying the methods, inputs and assumptions used to: (a) estimate the standalone selling price of each performance obligation and (b) allocate any discount or variable consideration included in the contract
- For rights of return or refund (or similar rights), the judgments involved in identifying the methods, inputs and assumptions used to estimate the related obligation

15.2.8 Practical expedients

15.2.8.1 Disclosures required for public entities and elective for nonpublic entities

If a public entity elected either of the following practical expedients, it should disclose that fact: (a) the practical expedient that results in not reflecting a significant financing component in the transaction price (see Section 7.4.1) or (b) the practical expedient that results in not capitalizing certain incremental costs related to obtaining a contract (see Section 13.2.1.2). As applicable, nonpublic entities may elect to make these disclosures.

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15.2.8.2 Disclosures required for nonpublic franchisors

If a nonpublic franchisor elected the practical expedient that permits a franchisor that enters into a franchise agreement to account for certain pre-opening services provided as distinct from the franchise license (see Section 6.1.5), it should disclose that fact.

15.2.9 Policy elections

15.2.9.1 Disclosures required for all entities

There are two policy elections that an entity may make which require additional disclosure:

- The accounting policy under which shipping and handling activities that occur after the customer obtains control of the promised goods are considered fulfilment activities and not promised services that have to be further evaluated under ASC 606 (see Section 6.1.2)
- The accounting policy under which the entity excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the entity's revenue-generating transactions with its customers (see Section 7.1.1)

If an entity elects either of these accounting policies, the following information should be disclosed:

- The fact the accounting policy has been elected
- A description of the accounting policy
- The method used to apply the accounting policy if such policy materially affects the balance sheet, cash flows or operating results

15.2.9.2 Disclosures required for nonpublic franchisors

If a nonpublic franchisor made an accounting policy election to account for certain pre-opening services as a single performance obligation (see Section 6.1.5), it should disclose that fact.

15.3 Disclosures required by ASC 340-40

15.3.1 Disclosures required for public entities and elective for nonpublic entities

The following information should be disclosed by public entities and may be disclosed by nonpublic entities:

- A description of the judgments made with respect to determining the amount of the following costs that should be capitalized under ASC 340-40: (a) the costs to fulfill a contract and (b) the incremental costs to obtain a contract
- A description of the method used in each reporting period to amortize the costs capitalized in accordance with ASC 340-40
- The ending balance of costs capitalized in accordance with ASC 340-40 by main category of asset (e.g., incremental costs to obtain a contract, setup costs)
- The amount of amortization recognized in the reporting period for the costs capitalized in accordance with ASC 340-40
- Any impairment losses recognized in the reporting period related to the costs capitalized in accordance with ASC 340-40
- If an entity elects the practical expedient allowing it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less, that fact

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Appendix A: Transfers of nonfinancial assets or in substance nonfinancial assets to counterparties other than customers

A.1 Overall scope of ASC 610-20

An entity may transfer (e.g., sell) nonfinancial assets that are not an output of its ordinary activities to a counterparty that is not a customer. For example, a bakery may sell its used delivery trucks to a dealership that sells used commercial vehicles (i.e., a noncustomer), or a clothing manufacturer may sell its used manufacturing equipment to an equipment restoration business (i.e., a noncustomer). These are transfers of nonfinancial assets to a party other than a customer that would fall within the scope of ASC 610-20. In addition, an entity may transfer to a counterparty that is not a customer an ownership (or variable) interest in a consolidated subsidiary that does not meet the definition of a business or nonprofit activity and for which substantially all of its fair value is concentrated in real estate. This is also the transfer of nonfinancial assets to a party other than a customer that would fall within the scope of ASC 610-20. These are just a few examples of the types of transfers involving nonfinancial assets for which ASC 610-20 is used to recognize any gain or loss resulting from the transfer. In addition, ASC 610-20 introduces the concept of in substance nonfinancial assets and provides guidance on how to account for transfers of such assets to counterparties other than customers.

It is important to keep in mind that ASC 610-20 is not the only guidance in the ASC that addresses transfers involving nonfinancial assets or in substance nonfinancial assets. As noted in the table that follows, various topics and subtopics in the ASC provide guidance that should be applied to recognize a gain or loss on the transfer of nonfinancial assets and in substance nonfinancial assets within their scope.

If the contract provides for the transfer of one (or a group of) nonfinancial assets and (or) in substance nonfinancial assets involving…	Account for the transfer using (if applicable [see Note 1])…
A counterparty that meets the definition of a customer and the generation of inflows meeting the definition of revenue	ASC 606
A subsidiary or group of assets that meet the definition of a business or nonprofit activity	ASC 810-10-40
A sale and leaseback transaction	ASC 360-20 or, or ASC 842 (see Section 3.3.2)
The conveyance of oil and gas mineral rights	ASC 932-360
The transfer of certain types of investments	ASC 860
Part of the consideration in a business combination	ASC 805-30-30-8
A nonmonetary transaction	ASC 845
A lease contract	ASC 842
An exchange of takeoff and landing slots	ASC 908-350
A contribution (including a promise to give)	ASC 720-25 or ASC 958-605, as applicable
An investment in a venture accounted for using proportionate consolidation	ASC 810-10-45-14

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If the contract provides for the transfer of one (or a group of) nonfinancial assets and (or) in substance nonfinancial assets involving…	Account for the transfer using (if applicable [see Note 1])…
Only entities under common control (e.g., parent and subsidiary, two subsidiaries of the same parent)	ASC 805-50 or other applicable GAAP

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and (or) the specific transfer being evaluated.

If there is no other applicable guidance in the ASC about how to account for the transfer of a nonfinancial asset or in substance nonfinancial asset to a counterparty other than a customer, the transfer is accounted for in accordance with ASC 610-20.

A.1.1 Determining whether the counterparty is a customer

A key differentiator between the types of transactions that fall within the scope of ASC 610-20 vs. ASC 606 is the counterparty to the transactions. Under ASC 610-20, the counterparty cannot be a customer, while under ASC 606, the counterparty must be a customer. As discussed in Section 3.1, customers obtain goods or services that are an output of the entity's ordinary activities. An example of a sale to a noncustomer discussed earlier was a bakery selling its used delivery trucks to a dealership that sells used commercial vehicles. The dealership is not a customer in this example because the output of the bakery's ordinary activities is baked goods, not used delivery trucks. As a result, the accounting for the bakery's sale of the used delivery trucks to the dealership falls within the scope of ASC 610-20. Conversely, the output of the dealership's ordinary activities is used commercial vehicles, including used delivery trucks. Because the counterparties to which the dealership sells its used commercial vehicles are customers, the accounting for those sales falls within the scope of ASC 606.

A.1.2 Different types of transfers

Typically, the transfer of nonfinancial assets and in substance nonfinancial assets involves the sale of the assets from the entity to the counterparty. However, other circumstances giving rise to the derecognition of nonfinancial assets or in substance nonfinancial assets also are considered transfers for purposes of the scope of ASC 610-20. Examples of these circumstances include the following:

- An existing contract expires or is terminated causing the entity to lose control of nonfinancial assets or in substance nonfinancial assets.
- A dilution event occurs causing the entity to lose control of nonfinancial assets or in substance nonfinancial assets.
- A government takes action causing the entity to lose control of nonfinancial assets or in substance nonfinancial assets.
- A subsidiary defaults on its nonrecourse debt causing the entity to lose control of the nonfinancial assets or in substance nonfinancial assets it used for collateral or other specifically identified nonfinancial assets or in substance nonfinancial assets.
- The entity contributes (i.e., loses control of) nonfinancial assets or in substance nonfinancial assets to a joint venture or other investee that it does not control.

A.1.3 Nonfinancial assets

Nonfinancial assets include tangible assets (e.g., vehicles, equipment, land, buildings) and intangible assets (e.g., a trademark, patented technology). In addition, the nonfinancial assets that are being transferred may have no carrying value (e.g., an internally generated intangible asset).

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It is important to note that ASC 610-20 addresses the transfer of intangible assets, not the license of intangible assets. For example, a technology company that licenses software to its customers should account for those licenses under ASC 606. If the technology company decides to sell the IP underlying the software to a third party that is not a customer, this sale should be accounted for under ASC 610-20.

A.1.4 In substance nonfinancial assets

ASC 610-20-15-5 defines an in substance nonfinancial asset as "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." Consider a situation in which an entity transfers both nonfinancial assets and financial assets to a counterparty that is not a customer. If the nonfinancial assets make up substantially all of the fair value of the assets transferred, the financial assets that are being transferred with the nonfinancial assets would be considered in substance nonfinancial assets, and their transfer would be within the scope of ASC 610-20.

A.1.5 Determining whether the sale of an ownership interest in a consolidated subsidiary that is not a business or nonprofit activity is within the scope of ASC 610-20

To determine whether the sale of an ownership interest in a consolidated subsidiary that is not a business or nonprofit activity falls within the scope of ASC 610-20, the entity must look through to the nature of the assets held by the subsidiary. Consider a situation in which an entity is transferring an ownership interest in a consolidated subsidiary that is not a business and that holds both financial and nonfinancial assets. If substantially all of the fair value of the consolidated subsidiary's assets is made up of nonfinancial assets, then the financial assets in that subsidiary are considered in substance nonfinancial assets, and the sale of an ownership interest in that consolidated subsidiary to a counterparty that is not a customer would be within the scope of ASC 610-20. Conversely, if less than substantially all of the fair value of the consolidated subsidiary's assets is made up of nonfinancial assets, then the financial assets in that subsidiary are not considered in substance nonfinancial assets, and the sale of an ownership interest in that consolidated subsidiary would not be within the scope of ASC 610-20. Instead, the sale of an ownership interest in that consolidated subsidiary should be accounted for in accordance with either ASC 810-10-40-3A(c) (if the transfer results in the entity losing control of the subsidiary [i.e., deconsolidation]) or ASC 810-10-45-21A(b)(2) (if the transfer does not result in the entity losing control of the subsidiary [i.e., no deconsolidation]), as applicable.

Also, consider a situation in which the contract between the entity and the counterparty (which is not a customer) requires the entity to transfer ownership interests in two or more consolidated subsidiaries that are not businesses or nonprofit activities and that hold both financial and nonfinancial assets. First, the entity considers whether substantially all of the fair value of all the assets promised in the contract is made up of nonfinancial assets:

- If so, the financial assets promised in the contract are considered in substance nonfinancial assets, and the sale of the ownership interests in the consolidated subsidiaries is within the scope of ASC 610-20.
- If not, the entity next considers whether substantially all of the fair value of the assets of each consolidated subsidiary (for which ownership interests are being transferred) is made up of nonfinancial assets:
  - For each subsidiary for which that is the case, the financial assets in that subsidiary are considered in substance nonfinancial assets, and the sale of an ownership interest in that consolidated subsidiary would be within the scope of ASC 610-20.
  - For each subsidiary for which that is not the case, the financial assets in that subsidiary are not considered in substance nonfinancial assets, and the sale of an ownership interest in that

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consolidated subsidiary would not be within the scope of ASC 610-20. Instead, the sale of ownership interests in that consolidated subsidiary should be accounted for in accordance with either ASC 810-10-40-3A(c) (if the transfer results in the entity losing control of the subsidiary [i.e., deconsolidation]) or ASC 810-10-45-21A(b)(2) (if the transfer does not result in the entity losing control of the subsidiary [i.e., no deconsolidation]), as applicable.

To allocate the contract consideration between those sales of an ownership interest that should be accounted for in accordance with ASC 610-20 and those that should be accounted for in accordance with either ASC 810-10-40-3A(c) or ASC 810-10-45-21A(b)(2), as applicable, the entity follows the guidance in Section 3.3 on contracts only partially within the scope of ASC 606. For this purpose, however, the guidance would be applied to separate the ASC 610-20 components from the non-ASC 610-20 components.

Consider the following example.



Example A-1: Transfer of ownership interests in two consolidated subsidiaries to a counterparty that is not a customer (ASC 610-20-55-9 to 55-10)

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.

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.

A.1.6 Exclusions from assets transferred

For purposes of determining whether substantially all of the fair value of the assets transferred to a counterparty in the contract is made up of nonfinancial assets:

- Cash and cash equivalents that will be transferred to the counterparty should be excluded.
- Liabilities assumed or relieved by the counterparty should not be considered.

The same also applies when an interest in a consolidated subsidiary is being transferred to the counterparty and the entity is determining whether substantially all of the fair value of the consolidated subsidiary's assets is concentrated in nonfinancial assets.

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A.1.7 Contracts only partially within the scope of ASC 610-20

To the extent the promises in a contract include more than transferring nonfinancial assets and in substance nonfinancial assets within the scope of ASC 610-20 (e.g., the contract also includes a guarantee), the promises within the scope of ASC 610-20 and the promises outside the scope of ASC 610-20 should be separated and measured based on the same guidance used to separate and measure components of a contract that are partially within the scope of ASC 606 and partially within the scope of other guidance in the ASC (see Section 3.3). For this purpose, however, the guidance would be applied to separate the ASC 610-20 components from the non-ASC 610-20 components. Consider the following example.



Example A-2: Transfer of real estate and the related operating leases, accounts receivable and a guarantee to a counterparty that is not a customer (ASC 610-20-55-2 to 55-5)

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.

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.

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.

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.



RSM COMMENTARY: It is important to note that the in-place lease intangible assets identified as a nonfinancial asset in this example should be identified as such regardless of whether the intangible asset has been recognized by the entity. In addition, this example illustrates the importance of separating the accounting for the seller's transfer of the nonfinancial assets and in substance nonfinancial assets from the accounting for the seller's guarantee that the transferred assets will generate sufficient cash flows.

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Example A-3: Transfer of machinery and financial assets to a counterparty that is not a customer (ASC 610-20-55-6 to 55-8)

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.

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.

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.



RSM COMMENTARY: This example highlights the need to separate the accounting for the transfer of nonfinancial assets from the accounting for the transfer of financial assets when those financial assets are not in substance nonfinancial assets. This example also highlights the effect of transferring the nonfinancial assets and financial assets outright vs. transferring ownership interests in a consolidated subsidiary that owns the nonfinancial assets and financial assets.

A.2 Accounting model in ASC 610-20

When accounting for a transfer within its scope, ASC 610-20 first requires an entity to apply the guidance in ASC 810 to determine whether it has (or retains) a controlling financial interest in the legal entity holding the nonfinancial assets and in substance nonfinancial assets after they are transferred. The results of this determination will dictate whether a gain or loss is recognized.

A.2.1 Determining whether the entity has a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets after they are transferred

The guidance in ASC 810 is applied first to determine whether the entity has (or retains) a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets after they are transferred. Making this determination depends on whether those assets were transferred directly to the counterparty or indirectly through the transfer of ownership interests in a consolidated subsidiary that is not a business:

- *Directly to the counterparty*. The entity determines whether it has a controlling financial interest in the counterparty.
- *Indirectly through the transfer of ownership interests in a consolidated subsidiary*. The entity determines whether it continues to have a controlling financial interest in the consolidated subsidiary.

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A.2.2 Accounting model when the entity has (or continues to have) a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets after they are transferred

If the entity has (or continues to have) a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets after they are transferred, those assets are not derecognized and a gain or loss is not recognized. Instead, the effects of the transfer are accounted for in equity similar to the accounting for other transactions in which the parent's controlling financial interest in a subsidiary decreases but remains a controlling financial interest (see ASC 810-10-45-21A to 45-24). Consider the following example.



Example A-4: Accounting for a transfer of nonfinancial assets and in substance nonfinancial assets when the entity retains a controlling financial interest in the legal entity that holds the assets after they are transferred

Company A owns 100 percent of Subsidiary B. Subsidiary B only owns one real estate asset and does not meet the definition of a business. Company A sells a 10 percent ownership interest in Subsidiary B to Counterparty C (an unrelated third party that is not a customer). Counterparty C pays $3 million for the 10 percent interest in Subsidiary B. The carrying amount of Subsidiary B's equity is $20 million.

Company A's transfer of the 10 percent ownership interest in Subsidiary B to Counterparty C is the transfer of an in substance nonfinancial asset within the scope of ASC 610-20 because:

- Subsidiary B is not a business.
- Counterparty C is not a customer.
- Substantially all of the fair value of Subsidiary B's assets is made up of nonfinancial assets.

Company A does not recognize a gain or loss upon the transfer of the 10 percent ownership interest in Subsidiary B to Counterparty C because Company A retains a controlling financial interest in Subsidiary B (the legal entity that holds the real estate after the 10 percent ownership interest is transferred). Instead, Company A records the following journal entry:

	Debit	Credit
Cash	$3,000,000	
Noncontrolling interest (Note 1)		$2,000,000
Additional paid-in capital (Note 2)		1,000,000

Note 1: $20,000,000 (carrying amount of Subsidiary B's equity) × 10% noncontrolling interest of Counterparty C

Note 2: Excess of cash paid for noncontrolling interest ($3 million) over amount recorded for the noncontrolling interest ($2 million)

A.2.3 Accounting model when the entity does not have (or retain) a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets after they are transferred

If the entity does not have (or retain) a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets after they are transferred to a counterparty that is not a customer, it accounts for the transfer by following steps that mirror the five steps in the revenue recognition model in ASC 606.

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Spotlight on change

In general, legacy GAAP related to revenue recognition was only applied to revenue-generating transactions. However, key aspects of ASC 606 should be applied to more than just revenue-generating transactions, such as the transfer of nonfinancial assets and in substance nonfinancial assets when the entity does not have a controlling financial interest in the legal entity that holds the assets after they are transferred. This creates the potential for significant changes in how an entity recognizes gains or losses on the sale of nonfinancial assets or in substance nonfinancial assets to a counterparty other than a customer.

A.2.3.1 Identify the contract with the counterparty

To identify the contract with the counterparty, the entity applies the guidance in ASC 606-10-25-1 to 25-8 (see Section 5.1 and Section 5.2). A key element of that guidance is application of the contract existence criteria. If the contract existence criteria are not met, the transferred nonfinancial assets and in substance nonfinancial assets are not derecognized and the entity continues to amortize or depreciate the assets as otherwise appropriate and apply the impairment guidance otherwise applicable to the assets (see ASC 350-10-40-3 for intangible assets and ASC 360-10-40-3C for property, plant and equipment). In addition, any consideration received by the entity is recognized as a liability until either: (a) the contract existence criteria are met and a gain or loss should otherwise be recognized under ASC 610-20 or (b) one of the circumstances discussed in Section 5.2.2 arises (e.g., the consideration received is nonrefundable and the contract has been terminated).

A.2.3.2 Identify each distinct nonfinancial asset and in substance nonfinancial asset

After the contract existence criteria are met, if the transfer involves multiple nonfinancial assets and (or) in substance nonfinancial assets that will be transferred to the counterparty at different points in time, the entity applies the guidance in ASC 606-10-25-19 to 25-22 (see Section 6.2) to determine whether each nonfinancial asset and in substance nonfinancial asset in the transfer is distinct. To the extent a nonfinancial asset or in substance nonfinancial asset is not distinct, it is combined with one or more other nonfinancial assets or in substance nonfinancial assets in the transfer until the group of assets would be considered distinct.

A.2.3.3 Determine the consideration promised

The consideration promised in a transfer of nonfinancial assets and in substance nonfinancial assets includes the transaction price for the transfer and the carrying amount of any liabilities assumed or relieved by the counterparty in the transfer.

The guidance in ASC 606-10-32-2 to 32-27 is applied to determine the transaction price (see Chapter 7) and ASC 606-10-32-42 to 32-45 is applied to account for changes in the transaction price (see Section 8.4). The transaction price includes fixed cash consideration, noncash consideration, variable consideration (subject to an overall constraint) and consideration payable to the counterparty. It also may need to reflect a significant financing component, depending on the facts and circumstances. A type of noncash consideration that may be promised in a transfer of nonfinancial assets and in substance nonfinancial assets is a noncontrolling interest in an entity (e.g., an equity method investment). ASC 606-10-32-21 to 32-24 should be used to measure that (and any other) noncash consideration received by the entity in the transfer (see Section 7.2). In addition, when the transfer of nonfinancial assets and in substance nonfinancial assets results in the entity indirectly losing control of those assets through the transfer of ownership interests in what was a consolidated subsidiary before the transfer, any noncontrolling interest retained in the former subsidiary should be treated as noncash consideration for purposes of determining the transaction price (see Example A-5).

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The carrying amount of any liabilities assumed or relieved by the counterparty in the transfer of nonfinancial assets and in substance nonfinancial assets should be included in the consideration promised in the transfer. However, in accordance with ASC 405-20-40-1, such liabilities should only be derecognized when either: (a) the counterparty pays off the liabilities and the entity is relieved of its obligations or (b) the entity is legally released as the primary obligor for the liabilities. If the gain or loss on the transfer is recognized before the liabilities assumed or relieved are derecognized, the entity applies the variable consideration constraint discussed in Section 7.3.3 to determine how much (if any) of the carrying amount of the liabilities should be included in the consideration promised for purposes of calculating the gain or loss on the transfer (see Example A-7). Section A.3.1 addresses the presentation issues that arise when the liabilities assumed or relieved by the counterparty are extinguished before or after the gain or loss on the transfer is recognized.

A.2.3.4 Allocate the consideration promised to the distinct nonfinancial assets and in substance nonfinancial assets

If the transfer involves multiple distinct nonfinancial assets and in substance nonfinancial assets for which control will be transferred to the counterparty at different points in time, the consideration promised for the transfer should be allocated to the distinct nonfinancial assets and in substance nonfinancial assets using the guidance in ASC 606-10-32-28 to 32-41 (see Chapter 8). This guidance results in using the standalone selling prices of the distinct nonfinancial assets and in substance nonfinancial assets to allocate the consideration promised on a relative standalone selling price basis to each of those assets, with limited exceptions.

A.2.3.5 Derecognize each distinct nonfinancial asset and in substance nonfinancial asset and recognize a gain or loss upon transfer of control

The guidance in ASC 606-10-25-30 (see Section 9.1) should be used to determine the point in time that control of a distinct nonfinancial asset or distinct in substance nonfinancial asset has transferred to the appropriate party. The identity of that party depends on whether the entity has a noncontrolling interest in the legal entity that holds the distinct nonfinancial asset or distinct in substance nonfinancial asset after it has been transferred:

- If the entity has a noncontrolling interest in the legal entity that holds the distinct nonfinancial asset or distinct in substance nonfinancial asset after the transfer, the entity determines the point in time control of the asset transfers to the legal entity.
- If the entity does not have a noncontrolling interest in the legal entity that holds the distinct nonfinancial asset or distinct in substance nonfinancial asset after the transfer, the entity determines the point in time control of the asset transfers to the counterparty.

At the point in time that control of a distinct nonfinancial asset or distinct in substance nonfinancial asset has transferred to the appropriate party, the resulting gain or loss is measured as the difference between the consideration promised that was allocated to the distinct nonfinancial asset or distinct in substance nonfinancial asset and the carrying amount of the asset.



Example A-5: Accounting for the transfer of a controlling interest in a subsidiary that only holds land and is not a business (ASC 610-20-55-11 to 55-16)

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.

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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.

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).

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.

Case B—Control Transfers under Topic 810 but Not under Topic 606

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.

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.

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RSM COMMENTARY: For Case A, the following journal entry illustrates the accounting effects on Entity A's consolidated financial statements of transferring ownership interests in a consolidated subsidiary (Entity B) that is not a business to a counterparty other than a customer (Entity X) when: (a) substantially all of the fair value of Entity B's assets is made up of nonfinancial assets (land), (b) Entity A loses control of Entity B (in accordance with ASC 810), but retains a noncontrolling investment in the legal entity that holds the land after it is transferred (Entity B), and (c) control of the land transfers from Entity A to Entity B (in accordance with ASC 606):

	Debit	Credit
Cash	$6,000,000	
Noncontrolling investment in Entity B	4,000,000	
Gain on transfer of nonfinancial assets		$5,000,000
Land		5,000,000

If Entity A had retained control over Entity B (e.g., Entity A only transferred 40 percent of the ownership interests in Entity B to Entity X), no gain or loss would have been recognized.

For Case B, the following journal entry illustrates the accounting effects on Entity A's consolidated financial statements of transferring ownership interests in a consolidated subsidiary (Entity B) that is not a business to a counterparty other than a customer (Entity X) in the same circumstances as Case A except control of the land does not transfer from Entity A to Entity B due to the existence of the call option:

	Debit	Credit
Cash	$6,000,000	
Financing liability		$6,000,000



Example A-6: Accounting for the transfer of in-process research and development when the consideration promised includes variable consideration (ASC 610-20-55-17 to 55-19)

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.

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.

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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.

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.



RSM COMMENTARY: In determining the consideration promised in the contract to transfer the in-process research and development to the counterparty, the entity had to consider the variable consideration guidance (including application of the variable consideration constraint) instead of the exception for sales- and usage-based royalties because the exception for sales- and usage-based royalties only applies to licenses of IP, not outright sales of IP.

The following journal entry is recorded by the entity upon transferring control of the in-process research and development to the counterparty:

	Debit	Credit
Cash	$5,000,000	
Loss on transfer of nonfinancial asset	45,000,000	
In-process research and development intangible asset		$50,000,000

The sales-based royalty is recognized as income when it is included in the transaction price, which may be as products derived from the in-process research and development are sold by the counterparty, because control of the in-process research and development already transferred to the counterparty at contract inception.

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A.3 Presentation

A.3.1 Balance sheet

Based on the guidance in ASC 606-10-45-1 to 45-5 (see Chapter 14), the entity should recognize a contract asset or contract liability for the difference between its performance (transferring the nonfinancial assets and in substance nonfinancial assets) and the counterparty's performance (transferring the consideration promised, including assuming or relieving any liabilities included in the transfer).

If control of the nonfinancial assets and in substance nonfinancial assets transfers to the counterparty before any liabilities the counterparty agreed to relieve or assume are relieved or assumed by the counterparty, the entity should:

- Derecognize the nonfinancial assets and in substance nonfinancial assets transferred to the counterparty
- Apply the variable consideration constraint discussed in Section 7.3.3 to determine how much (if any) of the carrying amount of the liabilities to be relieved or assumed by the counterparty should be included in the consideration promised for purposes of calculating the gain or loss on the transfer (see Example A-7)
- Recognize a gain or loss on the transfer of the nonfinancial assets and in substance nonfinancial assets transferred to the counterparty
- Recognize a contract asset for the amount of the liabilities the counterparty agreed to relieve or assume that was included in the consideration promised (after applying the variable consideration constraint)

The contract asset is then derecognized when the liabilities are relieved or assumed and derecognized by the entity in accordance with ASC 405-20-40-1.

If the counterparty relieves or assumes liabilities of the entity that were included in the transfer (such that they are derecognized in accordance with ASC 405-20-40-1) before control of the nonfinancial assets and in substance nonfinancial assets is transferred to the counterparty, the entity should:

- Derecognize the liabilities that were relieved or assumed by the counterparty
- Recognize a contract liability for the amount of the consideration promised that was received prior to transferring control of the nonfinancial assets and in substance nonfinancial assets

The contract liability is then derecognized when control of the nonfinancial assets and in substance nonfinancial assets is transferred to the counterparty, which leads to derecognizing those assets and recognizing any resulting gain or loss on the transfer.



Example A-7: Accounting for the transfer of nonfinancial assets that includes the counterparty relieving debt of the entity either before or after it obtains control of the nonfinancial asset

Company A and Counterparty B enter into a contract in which Company A will transfer a building to Counterparty B for $5 million in cash, and Counterparty B will relieve $2 million in Company A's debt. Counterparty B is not a customer and the nonfinancial asset (i.e., building) being transferred to Counterparty B is not a business. The carrying amount of the building on Company A's books is $3 million. The contract between Company A and Counterparty B meets all of the contract existence criteria.

Case 1: Control of the building transfers before the debt is relieved

Company A transfers control of the building to Counterparty B at contract inception, and Counterparty B transfers $5 million to Company A. Counterparty B relieves Company A's debt one month after contract

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inception such that it should be derecognized at that point in time in accordance with ASC 405-20-40-1. At contract inception, Company A applies the variable consideration guidance and determines that the full amount of the $2 million in its debt that Counterparty B is supposed to relieve in accordance with the contract should be included in the consideration promised.

The following journal entry would be recorded by Company A at contract inception:

	Debit	Credit
Cash	$5,000,000	
Contract asset	2,000,000	
Building		$3,000,000
Gain on transfer of building		4,000,000

One month after contract inception, Counterparty B relieves $2 million of Company A's debt. The following journal entry would be recorded by Company A at that point in time:

	Debit	Credit
Debt	$2,000,000	
Contract asset		$2,000,000

Case 2: Control of the building transfers after the debt is relieved

Counterparty B relieves Company A's debt at contract inception (such that it should be derecognized in accordance with ASC 405-20-40-1) and pays Company A $5 million. Company A transfers control of the building to Counterparty B one month after contract inception. The following journal entry would be recorded by Company A at contract inception:

	Debit	Credit
Cash	$5,000,000	
Debt	2,000,000	
Contract liability		$7,000,000

One month after contract inception, Company A transfers control of the building to Counterparty B. At that point in time, Company A would record the following journal entry:

	Debit	Credit
Contract liability	$7,000,000	
Building		$3,000,000
Gain on transfer of building		4,000,000

A.3.2 Income statement

The gain or loss on a transfer of long-lived nonfinancial assets and in substance nonfinancial assets that are not a discontinued operation should be included in income from continuing operations before income taxes. In addition, if an entity presents an operating income (or similar) subtotal, the gain or loss should be reflected in that subtotal.

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A.4 Disclosures

Information about transfers of nonfinancial assets and in substance nonfinancial assets should be disclosed in accordance with ASC 360-10-50-3 to 50-3A.

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Appendix B: Acronyms and literature references

Many acronyms are used throughout this guide and numerous references are made to specific topics and subtopics in the ASC. Provided in this appendix are: (a) an acronym legend, which lists the acronyms used throughout this guide and their corresponding definitions, and (b) a literature listing, which lists the topics and subtopics referred to throughout this guide and the corresponding titles.

B.1 Acronym legend

Acronym	Definition
AAG	AICPA Audit and Accounting Guide
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	Accounting Standards Update
CU	Currency unit
EITF	FASB Emerging Issues Task Force
FAR	Federal Acquisition Regulations
FASB	Financial Accounting Standards Board
FASB RRI Q&As	Financial Accounting Standards Board Revenue Recognition Implementation Q&As
FOB	Free on board
GAAP	U.S. Generally accepted accounting principles
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
IP	Intellectual property
IT	Information technology
NE&P	Nonrecurring engineering and preproduction
PBE	Public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
SaaS	Software as a service
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission
TP	Transaction Price
TRG	Transition Resource Group
VSOE	Vendor-specific objective evidence

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B.2 Literature listing

ASC topic or subtopic	Title
210-20	Balance Sheet—Offsetting
235	Notes to Financial Statements
250	Accounting Changes and Error Corrections
250-10	Accounting Changes and Error Corrections – Overall
280	Segment Reporting
310	Receivables
320	Investments—Debt Securities
321	Investments—Equity Securities
323	Investments—Equity Method and Joint Ventures
325	Investments—Other
326	Financial Instruments—Credit Losses
326-20	Financial Instruments—Credit Losses – Measured at Amortized Cost
330	Inventory
340	Other Assets and Deferred Costs
340-10	Other Assets and Deferred Costs – Overall
340-40	Other Assets and Deferred Costs – Contracts with Customers
350	Intangibles—Goodwill and Other
350-10	Intangibles—Goodwill and Other – Overall
350-40	Intangibles—Goodwill and Other – Internal-Use Software
360	Property, Plant, and Equipment
360-10	Property, Plant, and Equipment—Overall
360-20	Property, Plant, and Equipment—Real Estate Sales
405	Liabilities
405-20	Liabilities—Extinguishments of Liabilities
450	Contingencies
450-20	Contingencies—Loss Contingencies
460	Guarantees
470	Debt
605-20	Revenue Recognition—Services
605-25	Revenue Recognition—Multiple-Element Arrangements
605-35	Revenue Recognition—Construction-Type and Production-Type Contracts
606	Revenue from Contracts with Customers
606-10	Revenue from Contracts with Customers—Overall
610-20	Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets

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ASC topic or subtopic	Title
720-25	Other Expenses—Contributions Made
720-35	Other Expenses—Advertising Costs
805-30	Business Combinations—Goodwill or Gain from Bargain Purchase, Including Consideration Transferred
805-50	Business Combinations—Related Issues
808	Collaborative Arrangements
808-10	Collaborative Arrangements—Overall
810	Consolidation
810-10	Consolidation—Overall
815	Derivatives and Hedging
825	Financial Instruments
835-20	Interest—Capitalization of Interest
835-30	Interest—Imputation of Interest
842	Leases
845	Nonmonetary Transactions
853	Service Concession Arrangements
853-10	Service Concession Arrangements—Overall
860	Transfers and Servicing
905-605	Agriculture—Revenue Recognition
908-350	Airlines—Intangibles – Takeoff and Landing Slots
912-20	Contractors—Federal Government – Contract Costs
932-360	Extractive Activities—Oil and Gas – Property, Plant, and Equipment
944	Financial Services—Insurance
946-720	Financial Services—Investment Companies – Other Expenses
952-606	Franchisors—Revenue from Contracts with Customers
954-440	Health Care Entities—Commitments
954-450	Health Care Entities—Contingencies
954-605	Health Care Entities—Revenue Recognition
958-605	Not-for-Profit Entities—Revenue Recognition
980-350	Regulated Operations—Intangibles – Goodwill and Other
980-605	Regulated Operations—Revenue Recognition
985-20	Software—Costs of Software to Be Sold, Leased, or Marketed
985-605	Software—Revenue Recognition

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Abbreviation used herein	Responsible party	Title
ASU 2014-09	FASB	Revenue from Contracts with Customers (Topic 606)
ASU 2015-14	FASB	Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date
ASU 2016-08	FASB	Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
ASU 2016-10	FASB	Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing
ASU 2016-12	FASB	Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients
ASU 2016-20	FASB	Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers
ASU 2017-01	FASB	Business Combinations (Topic 805): Clarifying the Definition of a Business
ASU 2017-05	FASB	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 2017-10	FASB	Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services (a consensus of the FASB Emerging Issues Task Force)
ASU 2017-13	FASB	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 Rescission of Prior SEC Staff Announcements and Observer Comments (SEC Update)
ASU 2017-14	FASB	Income Statement—Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606) (SEC Update)
ASU 2018-07	FASB	Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting
ASU 2018-08	FASB	Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made
ASU 2018-18	FASB	Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606
ASU 2019-08	FASB	Compensation - Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements – Share-Based Consideration Payable to a Customer
ASU 2020-05	FASB	Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities

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Abbreviation used herein	Responsible party	Title
ASU 2020-10	FASB	Codification Improvements
ASU 2021-02	FASB	Franchisors – Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient
Concepts Statement 6	FASB	Elements of Financial Statements
IFRS 15	IASB	Revenue from Contracts with Customers
Issue 19-B	FASB - EITF	Issue No. 19-B, Revenue Recognition—Contract Modifications of Licenses of Intellectual Property
Regulation S-X, Rule 3-05	SEC	Financial Statements of Businesses Acquired or to Be Acquired
Regulation S-X, Rule 3-09	SEC	Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons
Regulation S-X, Rule 4-08(g)	SEC	General Notes to Financial Statements - Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons
Revenue Recognition AAG	AICPA	Audit and Accounting Guide, Revenue Recognition
SAB Topic 11M	SEC staff	Miscellaneous Disclosure – Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period
SAB Topic 13	SEC staff	Revenue Recognition
TRG 33	FASB	Partial Satisfaction of Performance Obligations Prior to Identifying the Contract
TRG 38	FASB	Portfolio Practical Expedient and Application of Variable Consideration Constraint
TRG 44	FASB	July 2015 Meeting – Summary of Issues Discussed and Next Steps
TRG 57	FASB	Capitalization and Amortization of Incremental Costs of Obtaining a Contract
Question 1	FASB - TRG	Are the rights and obligations of a credit card issuing bank's contract with the credit cardholder within the scope of Topic 606?
Question 2	FASB – TRG	Are cardholder rewards programs subject to Topic 606?
Question 3	FASB – TRG	Are incentive-based capital allocations, such as carried interest, within the scope of Topic 606?
Question 4	FASB – TRG	Is servicing and sub-servicing income within the scope of Topic 606?
Question 5	FASB – TRG	Are deposit-related fees within the scope of Topic 606?
Question 6	FASB – TRG	Are contributions included within the scope of Topic 606?
Question 7	FASB – TRG	How should termination clauses be evaluated in determining the duration of a contract (that is, the contractual period)?

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Abbreviation used herein	Responsible party	Title
Question 8	FASB – TRG	How do customer termination rights and penalties affect the identification of a contract duration?
Question 9	FASB – TRG	How should an entity assess collectibility for a portfolio of contracts?
Question 12	FASB – TRG	Should the evaluation of whether an option provides a material right be performed in the context of only the current transaction with a customer or should the evaluation also consider past and expected future transactions with the customer?
Question 13	FASB – TRG	Is the evaluation of whether an option provides a material right solely a quantitative evaluation or should the evaluation also consider qualitative factors?
Question 15	FASB – TRG	How should an entity account for a customer's exercise of a material right?
Question 16	FASB – TRG	How should an entity assess whether pre-production activities are a promised good or service (or included in the measure of progress toward complete satisfaction of a performance obligation that is satisfied over time)?
Question 18	FASB – TRG	In order to apply the series provision, how should an entity consider whether the performance obligation consists of distinct goods or services that are substantially the same?
Question 19	FASB – TRG	In order to apply the series provision, must the goods be delivered, or services performed consecutively?
Question 20	FASB – TRG	In order to apply the series provision (that is, account for the arrangement as single performance obligation), does the accounting result need to be the same as if the underlying distinct goods or services each were accounted for as separate performance obligations?
Question 21	FASB – TRG	When should an optional purchase be considered a separate performance obligation?
Question 22	FASB – TRG	What is the nature of the promise to the customer in arrangements described as stand-ready obligations?
Question 23	FASB – TRG	How can an entity distinguish optional purchases from variable consideration?
Question 25	FASB – TRG	Which payments to a customer are within the scope of the guidance on consideration payable to a customer?
Question 26	FASB – TRG	Who are considered an entity's customers when applying the guidance on consideration payable to a customer? Is this guidance meant to apply only to customers in the distribution chain or more broadly to any customer of an entity's customer?
Question 29	FASB – TRG	When should an entity recognize consideration payable to a customer? How does the guidance on timing and recognition of consideration payable reconcile with the variable consideration guidance?

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Abbreviation used herein	Responsible party	Title
Question 32	FASB – TRG	If the promised consideration is equal to the cash selling price, does a financing component exist?
Question 33	FASB – TRG	Does the standard preclude accounting for financing components that are not significant?
Question 37	FASB – TRG	How should the significant financing guidance be applied when there are multiple performance obligations?
Question 40	FASB – TRG	Can the estimated transaction price under the expected value method be an amount that is not a possible outcome of an individual contract?
Question 42	FASB – TRG	How should an entity account for restocking fees for widgets expected to be returned?
Question 46	FASB – TRG	In order to apply the practical expedient for measuring progress toward complete satisfaction of a performance obligation, may the practical expedient be applied to contracts with rates that change during the contract term?
Question 47	FASB – TRG	Can multiple measures of progress be utilized to depict an entity's performance in completing a combined performance obligation?
Question 48	FASB – TRG	How should an entity determine the measure of progress when a combined performance obligation satisfied over time contains multiple goods or services?
Question 49	FASB – TRG	How should an entity measure progress toward the complete satisfaction of a stand-ready obligation (that is, an obligation for which the entity has determined that the nature of the entity's promise is the service of "standing ready" to perform) that is satisfied over time?
Question 52	FASB – TRG	Over what periods should an entity recognize a nonrefundable upfront fee?
Question 54	FASB – TRG	Can an entity that recognized revenue at a point in time under current revenue recognition guidance be required to recognize revenue over time in accordance with Topic 606?
Question 55	FASB – TRG	In assessing whether an entity's performance creates an asset with no alternative use in accordance with paragraph 606-10-25-27(c), should an entity consider the completed asset or the in-production asset?
Question 59	FASB – TRG	How does a minimum guarantee impact the recognition of sales-based or usage-based royalties promised in exchange for a license of symbolic intellectual property?
Question 60	FASB – TRG	How does a minimum guarantee impact the recognition of sales-based or usage-based royalties promised in exchange for a license of functional intellectual property?
Question 61	FASB – TRG	How should an entity determine the presentation of a contract that contains multiple performance obligations?

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Abbreviation used herein	Responsible party	Title
Question 62	FASB – TRG	How should an entity determine the presentation of two or more contracts that have been combined under Step 1 (identify the contract with the customer) in accordance with paragraph 606-10-25-9?
Question 63	FASB – TRG	When can an entity offset other balance sheet items against the contract asset or liability?
Question 64	FASB – TRG	What is the appropriate accounting for reimbursements from customers for out-of-pocket expenses?
Question 65	FASB – TRG	Should customer reimbursements for pre-production costs be presented as revenue or contra expense?
Question 68	FASB – TRG	Should commission payments subject to clawback (that is, repayment to an entity if the customer does not perform) be capitalized as an incremental cost of obtaining a contract?
Question 69	FASB – TRG	Should commissions based on achieving cumulative targets be capitalized?
Question 71	FASB – TRG	How should an entity determine the amortization period of commissions paid on renewals after the initial contract is obtained?
Question 72	FASB – TRG	How should an entity evaluate whether a commission paid for a renewal is “commensurate with” a commission paid on the initial contract (when determining the appropriate amortization period for an initial commission)?
Question 74	FASB – TRG	Should an entity consider fringe benefits in the assessment of determining the amount of commissions to record as incremental costs (for example, payroll taxes, pension / 401K match, FICA)
Question 75	FASB – TRG	How should an entity determine the pattern of amortization for a contract cost asset that relates to multiple performance obligations that are satisfied over disparate points or periods of time?
Question 76	FASB – TRG	How should an entity account for fulfillment costs incurred before the Contract Establishment Date (CED)?
Question 77	FASB – TRG	How should an entity account for restocking costs for expected widget returns (for example, estimated shipping or repackaging costs)?
Question 78	FASB – TRG	Which costs to obtain a contract are incremental?
Question 79	FASB – TRG	How should an entity determine the amortization period for an asset recognized for the incremental costs of obtaining a contract with a customer?

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Appendix C: ASC 606 disclosure checklist for public entities

This checklist includes the disclosures required of public entities, while a separate checklist in Appendix D includes the disclosures required of nonpublic entities that do not elect to provide the disclosures otherwise required of public entities. For this purpose:

- Public entities include: (a) PBEs, (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC.
- Nonpublic entities include all entities other than public entities.

For additional information about the type of entities considered PBEs and public entities, refer to our summary, Q&A on the public business entity definition.

C.1 Interim disclosures

This checklist includes both the annual and interim disclosures required of public entities by ASC 606 and ASC 340-40 and the revenue-related disclosures required of public entities by ASC 270, "Interim Reporting," and ASC 460, "Guarantees." When a public entity applies ASC 606 and ASC 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and ASC 340-40 in its annual financial statements, the public entity must provide all the required annual disclosures in this checklist in those interim financial statements. After the public entity applies ASC 606 and ASC 340-40 in its annual financial statements for the first time (and provides all the required annual disclosures), only the required interim disclosures need to be included in its future interim financial statements, unless there has been a significant change in the information disclosed in its most recent annual financial statements.

For example, consider a public entity with a calendar year end that files financial statements with the SEC on a quarterly basis and did not adopt ASC 606 and ASC 340-40 early. This public entity should include all of the annual disclosures required by ASC 606 and ASC 340-40 in: (a) the interim financial statements it files with the SEC for its quarters ended March 31, June 30 and September 30, 2018 and (b) the annual financial statements it files with the SEC for its year ended December 31, 2018. Going forward, the public entity only needs to include the interim disclosures required by ASC 606, ASC 340-40 and 270 in the interim financial statements it files with the SEC, unless there has been a significant change in the information disclosed in its prior year annual financial statements.

C.2 Level of detail or disaggregation

In some cases, the level of detail or disaggregation required of an entity in complying with the specific disclosure requirements in ASC 606 and ASC 340-40 will be apparent within a specific disclosure requirement itself. In other cases, the level of detail required is the level of detail needed to achieve the overall disclosure objective of ASC 606. In addition, ASC 606-10-50-2 indicates the following with respect to the level of disaggregation required: "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."

C.3 Periods or period ends to which the specific disclosure requirements apply

If the disclosure requirement relates to an income statement item (e.g., revenue recognized under ASC 606), the required information should be disclosed for all periods reflecting application of ASC 606 and ASC 340-40 that are included in the income statement. If the disclosure relates to a balance sheet item (e.g., contract assets and liabilities), the required information should be disclosed for each balance sheet presented that reflects the application of ASC 606 and ASC 340-40.

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C.4 Duplicative disclosure requirements

If the entity discloses information to comply with requirements in other guidance in the ASC and that information also satisfies a disclosure requirement in ASC 606 or ASC 340-40, the entity need not repeat the information in its ASC 606 or ASC 340-40 disclosures.

C.5 Disclosure checklist for public entities

ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
Certain overall revenue-related amounts					
326-20-50 606-10-50-4	15.2.1.1	1. Have the following amounts for the reporting period either been separately presented on the face of the income statement or disclosed in the notes to the financial statements: a. Revenue recognized from the entity's contracts with customers? (Note: This amount should not be included with revenue from other sources.) b. Impairment (or credit) losses on accounts receivable or contract assets related to the entity's contracts with customers that were recognized in accordance with ASC 310, "Receivables" (or ASC 326-20, "Financial Instruments—Credit Losses—Measured at Amortized Cost")? (Note: These amounts should not be included with impairment [or credit] losses on other contracts.)	No		
		Additional interim and annual disclosures related to credit losses are required under ASC 326-20. For additional information about those disclosures, see ASC 326-20-50.			
Disaggregated revenue					
270-10-50-1A(a) 606-10-50-5 606-10-50-7 606-10-55-89 to 55-91 606-10-55-296 to 55-297	15.2.2.1	2. Has a quantitative disaggregation of revenue based on how economic factors affect the nature, amount, timing and uncertainty of revenue recognition and cash flows been disclosed?	Yes		
		Examples of the categories by which it may be appropriate for an entity to disaggregate revenue for this disclosure include: • The types of goods or services the entity provides • The geographic regions of the entity's operations			

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
		• The types of customers the entity serves • The types of markets the entity serves • The types of customer contracts into which the entity enters • The duration of the entity's contracts with customers • The timing of when the entity transfers the goods or services to its customers • The sales channels the entity uses When determining the categories it should use for purposes of disaggregating its revenue in the footnotes to the financial statements, an entity should consider whether, and if so how, it has disaggregated revenue for other purposes (if any). To this end, ASC 606-10-55-90 indicates an entity should consider whether it has disaggregated revenue for any of the following other purposes: 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. If an entity has disaggregated revenue for any of these purposes, it should consider the categories used and whether they also should be used for purposes of disaggregating revenue in the footnotes to the financial statements. The number of categories by which an entity should disaggregate its revenue depends on the facts and circumstances. As a result, the number of categories used likely will vary by entity, with some entities using more categories than other entities.			
270-10-50-1A(a) 606-10-50-6	15.2.2.1	3. In the revenue information disclosed for each reportable segment in accordance with ASC 280, "Segment Reporting," has the entity also disclosed information that facilitates users of the financial statements understanding the relationship between that revenue information and the disaggregated revenue information disclosed in accordance with ASC 606?	Yes		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
Contract balances					
270-10-50-1A(b) 606-10-50-8(a) 606-10-50-11	15.2.3.1	4. Have the opening and closing balances of accounts receivable, contract assets and contract liabilities for all periods presented been disclosed or separately presented on the face of the balance sheet?	Yes		
		Separately presenting the balances on the face of the balance sheet will not meet all the required disclosures since the opening balances of accounts receivable, contract assets and contract liabilities for the comparative period are not presented on the face of the balance sheet. Therefore, the opening balances for the comparative period will need to be disclosed elsewhere in the accompanying notes.			
270-10-50-1A(c) 606-10-50-8(b) 606-10-50-11	15.2.3.2	5. Has the amount of revenue recognized in the current reporting period that was included in the contract liability balance at the end of the previous reporting period been disclosed?	Yes		
		For example, if an entity had a contract liability balance at the end of the previous reporting period due to it receiving upfront nonrefundable payments for which it had not yet fully performed, it should disclose the amount of that liability that was recognized as revenue in the current reporting period.			
606-10-50-9 606-10-50-11	15.2.3.2	6. Has the following information been disclosed: a. An explanation about the relationship between the timing of the entity's satisfaction of its performance obligations and the timing of when it typically receives payment for providing the underlying goods or services? b. An explanation (which may be qualitative) as to how the contract asset and contract liability balances are affected by the timing factors described in 6(a)?	No		
		For example, when a construction contractor constructs buildings for its customers, it should disclose the timing of transferring control of the buildings to its customers as compared to the timing of when it receives payments from those customers and explain how this timing affects any related contract asset or contract liability balances.			
606-10-50-10	15.2.3.2	7. Has a qualitative and quantitative explanation of what caused significant changes in the contract	No		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
606-10-50-11		assets or contract liabilities during the reporting period been disclosed?			
		ASC 606-10-50-10 lists the following as examples of what could cause a change in a contract asset or liability: 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).			
Performance obligations					
606-10-50-12(a)	15.2.4.1	8. Has a description of when the entity typically satisfies its performance obligations been disclosed?	No		
		For example, an entity may disclose that it typically satisfies performance obligations consisting of products upon delivery of those products because that is when control of the products transfers to the customer.			
606-10-50-12(a)	15.2.4.1	9. If there are performance obligations in bill-and-hold arrangements, has a description of when those performance obligations are satisfied been specifically disclosed?	No		
606-10-50-12(b)	15.2.4.1	10. Has a description of the significant payment terms for contracts with customers been disclosed, including, for example, the following: a. When payments are typically due from customers? b. Whether the contracts include significant financing components? c. Whether the contracts include variable consideration, and if so, whether application of the variable consideration constraint results in the amount of variable consideration included in the transaction price being constrained?	No		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
606-10-50-12(c)	15.2.4.1	11. Has a description of the nature of the promised goods or services in the entity's contracts with its customers been disclosed?	No		
606-10-50-12(c)	15.2.4.1	12. Has a description of the nature of the entity's promised goods or services in any situations in which the entity is acting as an agent (i.e., arranging for another party to transfer promised goods or services to the customer) been specifically disclosed?	No		
606-10-50-12(d)	15.2.4.1	13. Has a description of the obligations in the entity's contracts with its customers related to rights of return or refund or other similar customer rights been disclosed?	No		
		For example, a retailer that provides customers with the right of return should describe the obligation it has to its customers related to that right.			
606-10-50-12(e)	15.2.4.1	14. Have descriptions of the types of warranties and related obligations related to what the entity provides to its customers been disclosed?	No		
460-10-50-4 460-10-50-8	6.5	15. For service-type warranties, has the following information been disclosed: a. The nature of the warranties, including: • The warranties' approximate terms? • How the warranties arose? • The events or circumstances under which the entity would have to perform under the warranties? • The current status of the payment/performance risk of the warranties, and if internal groupings are used for this purpose, how those groupings are determined and used for managing risk? b. The current carrying amount of the liability for the entity's obligations under the warranties (if any)? c. The nature of any recourse provisions that would enable the entity to recover from third parties amounts paid under the warranties? d. If there are assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the warranties, the entity can obtain and liquidate to recover all or a portion of the amounts paid under the warranties, the following: • The nature of the assets? • The approximate extent to which the proceeds from liquidation of the assets	No		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
		would be expected to cover the maximum potential amount of future payments under the warranties (if estimable)? e. The accounting policy and methodology used in determining the liability for the entity's obligations under the warranties? f. A tabular reconciliation of the changes in the liability for the entity's obligations under the warranties for the reporting period, including the following amounts: • Beginning balance of the liability? • Aggregate decrease in the liability for payments made (cash or in kind) under the warranties? • Aggregate changes in the liability for accruals related to warranties issued during the reporting period? • Aggregate changes in the liability for accruals related to warranties issued in prior periods (e.g., change in estimate related to pre-existing warranties that remain open)? • Ending balance of the liability?			
		If the customer has the option to purchase a warranty, the warranty represents a performance obligation and is accounted for separately. If such an option does not exist, the entity must determine whether it is providing: (a) only a warranty that the product complies with agreed-upon specifications (i.e., an assurance-type warranty) or (b) a service (e.g., maintenance) in addition to the assurance-type warranty (i.e., a service-type warranty). If the warranty goes beyond an assurance-type warranty, the entity must determine whether it can reasonably account for the assurance-type warranty separate from the service-type warranty. If the entity can reasonably account for the two warranties separate from each other, the assurance-type warranty is accounted for under ASC 460, and the service-type warranty is accounted for as a performance obligation under ASC 606. If the entity cannot reasonably account for the two warranties separate from each other, both warranties are accounted for together as a single performance obligation under ASC 606. For additional information about how to account for assurance-type and service-type warranties, see Section 6.5.			

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
270-10-50-1A(d) 606-10-50-11 606-10-50-12A	15.2.4.1	16. Has the amount of revenue recognized in the current reporting period related to performance obligations satisfied (or partially satisfied) in the prior reporting period been disclosed?	Yes		
		For example, an entity should disclose the sales-based royalties it recognized in the current period related to a license of functional IP that was satisfied at a point in time in a prior period.			
Transaction price allocated to remaining performance obligations					
270-10-50-1A(e) 606-10-50-13 to 50-16 606-10-55-298 to 55-307	15.2.5 15.2.5.1	17. Has the following information about an entity's remaining performance obligations at the end of the reporting period been disclosed: a. The total amount of the transaction price allocated to those remaining performance obligations? b. An explanation of when the entity expects to recognize the transaction price allocated to those performance obligations as revenue? (Note: This explanation may be either quantitative [using appropriate time bands for when the allocated transaction price is expected to be recognized as revenue] or qualitative.) The following optional exemptions may be elected related to these disclosures: (1) The disclosures in 17(a) and (b) do not have to be provided if either: (i) The original expected duration of the customer contract to which the remaining performance obligations relate is one year or less. (ii) The consideration is not fixed and the entity qualifies for and is using the practical expedient that allows it to recognize revenue for the amount it has a right to invoice (see ASC 606-10-55-18). (2) Information related to variable consideration does not have to be included in the disclosures in 17(a) and (b) if either: (i) The sales- and (or) usage-based royalty exception (see ASC 606-10-55-65 to 55-65B) applies to the variable consideration. (ii) The variable consideration has been allocated in its entirety to either the wholly unsatisfied performance obligation to which it specifically relates, or the wholly	Yes		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
		unsatisfied distinct good or service in a single performance obligation resulting from the series exception to which it specifically relates (see ASC 606-10-32-39 and 32-40). If one or more of the optional exemptions has been elected, has the following information been disclosed instead of what would otherwise be disclosed under 17(a) and (b): c. The optional exemption(s) elected? d. The nature and remaining duration of the remaining performance obligations? e. A description of any variable consideration excluded from the disclosures in 17(a) and (b) as a result of electing one or more of the optional exemptions? f. Any other information necessary to provide users of the financial statements with the information needed to understand the remaining performance obligations excluded from the disclosures in 17(a) and (b) as a result of electing one or more of the optional exemptions? Note in the Remarks column which (if any) of the optional exemptions were elected. In addition, refer to the practical expedient in 37.			
		Remaining performance obligations are those performance obligations identified in a customer contract that was entered into before the end of the reporting period for which control of some or all of the underlying goods or services has not been transferred to the customer at the end of the reporting period. A remaining performance obligation may be a partially satisfied performance obligation or a completely unsatisfied performance obligation. An example of the disclosure in 17(a) is a construction contractor that discloses the amount of transaction price allocated to the remaining performance obligations it has under its incomplete contracts with customers at the end of the reporting period. An example of the disclosure in 17(b) is a software company that discloses the time bands related to when it expects to recognize the transaction price allocated to the remaining performance obligations it has under its incomplete contracts with customers at the end of the reporting period. To the extent the customer contract includes both fixed and variable consideration (e.g., sales-based royalty with a guaranteed minimum), optional exemptions (1)(ii) and (2) only apply to the variable			

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
		consideration (e.g., optional exemptions (1)(ii) and (2) would not apply to the guaranteed minimum sales-based royalty).			
270-10-50-1A(e) 606-10-50-15 to 50-16	15.2.5.1	18. Has an explanation with respect to whether there is any consideration not included in the transaction price (perhaps due to the variable consideration constraint) been disclosed?	Yes		
		Any consideration not included in the transaction price would also not be included in the disclosures in 17.			
Significant judgments about the timing of satisfying performance obligations					
606-10-50-18(a) 606-10-50-21	15.2.6.1	19. For performance obligations satisfied over time, have the specific input or output method(s) used to recognize revenue over time, and how those methods are applied, been disclosed?	No		
606-10-50-18(b) 606-10-50-21(a)	15.2.6.2	20. For performance obligations satisfied over time, has an explanation been disclosed about why the specific input or output method used to recognize revenue over time provides a faithful depiction of how the entity transfers control of goods or services to its customers?	No		
606-10-50-19 606-10-50-21(b)	15.2.6.2	21. For performance obligations satisfied at a point in time, have the significant judgments made in determining when control of the goods or services transfers to customers been disclosed?	No		
Significant judgments about the transaction price and the amounts allocated to performance obligations					
606-10-50-20(a) 606-10-50-21(c)	15.2.7.2	22. Has information about the judgments involved in identifying the methods, inputs and assumptions used to determine the transaction price and measure any obligations related to customer contracts (e.g., returns, refunds), including (but not limited to) the following, been disclosed: a. If there is variable consideration, an explanation of how the entity estimates the variable consideration (e.g., the most likely amount method or the expected value method)? b. If there is a significant financing component included in the contracts, an explanation of how the entity reflected that component in the transaction price? c. If there is noncash consideration included in the contracts, an explanation of how the entity measured that consideration?	No		
606-10-50-20(b)	15.2.7.1	23. Have the judgments involved in identifying the methods, inputs and assumptions used in the	No		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
606-10-50-21(c)		application of the variable consideration constraint been disclosed?			
606-10-50-20(c) 606-10-50-21(c)	15.2.7.2	24. For customer contracts that include more than one performance obligation, have the judgments involved in identifying the methods, inputs and assumptions used to do the following been disclosed: a. Estimate the standalone selling price of each performance obligation? b. Allocate any discount or variable consideration included in the contract?	No		
606-10-50-20(d) 606-10-50-21(c)	15.2.7.2	25. For rights of return or refund (or similar rights), have the judgments involved in identifying the methods, inputs and assumptions used to estimate the related obligation been disclosed?	No		
Accounting policy elections					
235-10-50-1 to 50-6 606-10-25-18B	6.1.2	26. If the entity has elected the accounting policy under which shipping and handling activities that occur *after* the customer obtains control of the promised goods are considered fulfilment activities and not promised services that have to be further evaluated under ASC 606, has the following information been disclosed: a. The fact the accounting policy has been elected? b. A description of the accounting policy? c. The method used to apply the accounting policy if such policy materially affects the balance sheet, cash flows or operating results?	No		
235-10-50-1 to 50-6 606-10-32-2A	7.1.1	27. If the entity has elected the accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the entity's revenue-generating transactions with its customers, has the following information been disclosed: a. The fact the accounting policy has been elected? b. A description of the accounting policy? c. The method used to apply the accounting policy if such policy materially affects the balance sheet, cash flows or operating results?	No		
Practical expedients					
606-10-50-22 to 50-23	15.2.8.1	28. If the practical expedient that results in not reflecting a significant financing component in the	No		

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ASC	RSM guide section	Annual disclosure requirements for public entities	Interim?	Yes/ No	Remarks
		transaction price (see ASC 606-10-32-18) has been elected, has that election been disclosed?			
Costs to obtain or fulfill a customer contract					
340-40-50-2(a) 340-40-50-4	15.3.1	29. Have descriptions of the judgments made with respect to determining the amount of the following costs that should be capitalized under ASC 340-40 been disclosed: a. The costs to fulfill a customer contract? b. The incremental costs to obtain a customer contract?	No		
340-40-50-2(b) 340-40-50-4	15.3.1	30. Has a description of the method used in each reporting period to amortize the costs capitalized in accordance with ASC 340-40 been disclosed?	No		
340-40-50-3(a) 340-40-50-4	15.3.1	31. Has the ending balance of costs capitalized in accordance with ASC 340-40 by main category of asset (e.g., incremental costs to obtain a customer contract, setup costs) been disclosed?	No		
340-40-50-3(b) 340-40-50-4	15.3.1	32. Has the amount of amortization recognized in the reporting period for the costs capitalized in accordance with ASC 340-40 been disclosed?	No		
340-40-50-3(b) 340-40-50-4	15.3.1	33. Have any impairment losses recognized in the reporting period related to the costs capitalized in accordance with ASC 340-40 been disclosed?	No		
340-40-50-5 to 50-6 606-10-50-22 to 50-23	15.3.1	34. If an entity elects the practical expedient allowing it to expense the incremental costs to obtain a customer contract if the amortization period for those costs would otherwise be one year or less (see ASC 340-40-25-4), has that election been disclosed?	No		

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Appendix D: ASC 606 disclosure checklist for nonpublic entities

This checklist includes the minimum disclosures required of nonpublic entities, while the checklist in Appendix C includes the disclosures required of public entities on both an interim and annual basis. For this purpose:

- Public entities include: (a) PBEs, (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC.
- Nonpublic entities include all entities other than public entities.

For additional information about the type of entities considered PBEs and public entities, refer to our summary, Q&A on the public business entity definition.

Nonpublic entities that wish to provide disclosures beyond those specifically required of them should use the disclosure checklist for public entities in Appendix C.

This checklist includes the disclosures required of nonpublic entities by ASC 606 and ASC 340-40 and the revenue-related disclosures required of nonpublic entities by ASC 460.

D.1 Level of detail or disaggregation

In some cases, the level of detail or disaggregation required of an entity in complying with the specific disclosure requirements in ASC 606 and ASC 340-40 will be apparent within a specific disclosure requirement itself. In other cases, the level of detail required is the level of detail needed to achieve the overall disclosure objective of ASC 606. In addition, ASC 606-10-50-2 indicates the following with respect to the level of disaggregation required: “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.”

D.2 Periods or period ends to which the specific disclosure requirements apply

If the disclosure requirement relates to an income statement item (e.g., revenue recognized under ASC 606), the required information should be disclosed for all periods reflecting application of ASC 606 and 340-40 that are included in the income statement. If the disclosure relates to a balance sheet item (e.g., contract assets and liabilities), the required information should be disclosed for each balance sheet presented that reflects the application of ASC 606 and ASC 340-40.

D.3 Duplicative disclosure requirements

If the entity discloses information to comply with requirements in other guidance in the ASC and that information also satisfies a disclosure requirement in ASC 606 or ASC 340-40, the entity need not repeat the information in its ASC 606 or ASC 340-40 disclosures.

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D.5 Disclosure checklist for nonpublic entities

ASC	RSM guide section	Annual disclosure requirements	Yes/ No	Remarks
Certain overall revenue-related amounts				
326-20-50 606-10-50-4	15.2.1.1	1. Have the following amounts for the reporting period either been separately presented on the face of the income statement or disclosed in the notes to the financial statements: a. Revenue recognized from the entity's contracts with customers? (Note: This amount should not be included with revenue from other sources.) b. Impairment (or credit) losses on accounts receivable or contract assets related to the entity's contracts with customers that were recognized in accordance with ASC 310, "Receivables" (or ASC 326-20, "Financial Instruments—Credit Losses—Measured at Amortized Cost")? (Note: These amounts should not be included with impairment [or credit] losses on other contracts.)		
		Additional interim and annual disclosures related to credit losses are required under ASC 326-20. For additional information about the disclosures required, see ASC 326-20-50.		
Disaggregated revenue				
606-10-50-7	15.2.2.2	2. Has the following disaggregated information been disclosed: a. Disaggregated revenue based on when control of the goods or services transfers to the customer (e.g., over time or at a point in time)? b. Qualitative information about how economic factors (such as those that might otherwise serve as the basis for quantitative disaggregation) affect the nature, amount, timing and uncertainty of revenue recognition and cash flows?		
		Examples of the categories by which it may be appropriate for an entity to quantitatively disaggregate revenue if such disaggregation was otherwise required include: • The types of goods or services the entity provides • The geographic regions of the entity's operations • The types of customers the entity serves • The types of markets the entity serves • The types of customer contracts into which the entity enters • The duration of the entity's contracts with customers • The timing of when the entity transfers the goods or services to its customers • The sales channels the entity uses		
Contract balances				
270-10-50-1A(b)	15.2.3.1	3. Have the opening and closing balances of accounts receivable, contract assets and contract liabilities for all		

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ASC	RSM guide section	Annual disclosure requirements	Yes/ No	Remarks
606-10-50-8(a) 606-10-50-11		periods presented been disclosed or separately presented on the face of the balance sheet?		
		Separately presenting the balances on the face of the balance sheet will not meet all the required disclosures since the opening balances of accounts receivable, contract assets and contract liabilities for the comparative period are not presented on the face of the balance sheet. Therefore, the opening balances for the comparative will need to be disclosed elsewhere in the accompanying notes.		
Performance obligations				
606-10-50-12(a)	15.2.4.1	4. Has a description of when the entity typically satisfies its performance obligations been disclosed?		
		For example, an entity may disclose that it typically satisfies performance obligations consisting of products upon delivery of those products because that is when control of the products transfers to the customer.		
606-10-50-12(a)	15.2.4.1	5. If there are performance obligations in bill-and-hold arrangements, has a description of when those performance obligations are satisfied been specifically disclosed?		
606-10-50-12(b)	15.2.4.1	6. Has a description of the significant payment terms for contracts with customers been disclosed, including, for example, the following: a. When payments are typically due from customers? b. Whether the contracts include significant financing components? c. Whether the contracts include variable consideration, and if so, whether application of the variable consideration constraint results in the amount of variable consideration included in the transaction price being constrained?		
606-10-50-12(c)	15.2.4.1	7. Has a description of the nature of the promised goods or services in the entity's contracts with its customers been disclosed?		
606-10-50-12(c)	15.2.4.1	8. Has a description of the nature of the entity's promised goods or services in any situations in which the entity is acting as an agent (i.e., arranging for another party to transfer promised goods or services to the customer) been specifically disclosed?		
606-10-50-12(d)	15.2.4.1	9. Has a description of the obligations in the entity's contracts with its customers related to rights of return or refund or other similar customer rights been disclosed?		
		For example, a retailer that provides customers with the right of return should describe the obligation it has to its customers related to that right.		

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ASC	RSM guide section	Annual disclosure requirements	Yes/ No	Remarks
606-10-50-12(e)	15.2.4.1	10. Have descriptions of the types of warranties and related obligations related to what the entity provides to its customers been disclosed?		
460-10-50-4 460-10-50-8	6.5	11. For service-type warranties, has the following information been disclosed: a. The nature of the warranties, including: • The warranties' approximate terms? • How the warranties arose? • The events or circumstances under which the entity would have to perform under the warranties? • The current status of the payment/performance risk of the warranties, and if internal groupings are used for this purpose, how those groupings are determined and used for managing risk? b. The current carrying amount of the liability for the entity's obligations under the warranties (if any)? c. The nature of any recourse provisions that would enable the entity to recover from third parties amounts paid under the warranties? d. If there are assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the warranties, the entity can obtain and liquidate to recover all or a portion of the amounts paid under the warranties, the following: • The nature of the assets? • The approximate extent to which the proceeds from liquidation of the assets would be expected to cover the maximum potential amount of future payments under the warranties (if estimable)? e. The accounting policy and methodology used in determining the liability for the entity's obligations under the warranties? f. A tabular reconciliation of the changes in the liability for the entity's obligations under the warranties for the reporting period, including the following amounts: • Beginning balance of the liability? • Aggregate decrease in the liability for payments made (cash or in kind) under the warranties? • Aggregate changes in the liability for accruals related to warranties issued during the reporting period? • Aggregate changes in the liability for accruals related to warranties issued in prior periods (e.g., change in estimate related to pre-existing warranties that remain open)? • Ending balance of the liability?		
		If the customer has the option to purchase a warranty, the warranty represents a performance obligation and is accounted for separately. If such an option does not exist, the entity must		

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ASC	RSM guide section	Annual disclosure requirements	Yes/ No	Remarks
		determine whether it is providing: (a) only a warranty that the product complies with agreed-upon specifications (i.e., an assurance-type warranty) or (b) a service (e.g., maintenance) in addition to the assurance-type warranty (i.e., a service-type warranty). If the warranty goes beyond an assurance-type warranty, the entity must determine whether it can reasonably account for the assurance-type warranty separate from the service-type warranty. If the entity can reasonably account for the two warranties separate from each other, the assurance-type warranty is accounted for under ASC 460, and the service-type warranty is accounted for as a performance obligation under ASC 606. If the entity cannot reasonably account for the two warranties separate from each other, both warranties are accounted for together as a single performance obligation under ASC 606. For additional information about how to account for assurance-type and service-type warranties, see Section 6.5.		
Significant judgments about the timing of satisfying performance obligations				
606-10-50-18(a) 606-10-50-21	15.2.6.1	12. For performance obligations satisfied over time, have the specific input or output method(s) used to recognize revenue over time, and how those methods are applied, been disclosed?		
Significant judgments about the transaction price				
606-10-50-20(b) 606-10-50-21(c)	15.2.7.1	13. Have the judgments involved in identifying the methods, inputs and assumptions used in the application of the variable consideration constraint been disclosed?		
Accounting policy elections and certain practical expedients				
235-10-50-1 to 50-6 606-10-25-18B	6.1.2	14. If the entity has elected the accounting policy under which shipping and handling activities that occur *after* the customer obtains control of the promised goods are considered fulfilment activities and not promised services that have to be further evaluated under ASC 606, has the following information been disclosed: a. The fact the accounting policy has been elected? b. A description of the accounting policy? c. The method used to apply the accounting policy if such policy materially affects the balance sheet, cash flows or operating results?		
952-606-50-1	6.1.5	15. If a franchisor has elected to use the practical expedient in ASC 952-606-25-2, has the fact that this practical expedient was elected been disclosed?		
952-606-50-2	6.1.5	16. If a franchisor has elected the accounting policy under which the pre-opening services are accounted for as a single		

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ASC	RSM guide section	Annual disclosure requirements	Yes/ No	Remarks
		performance obligation, has the fact that this accounting policy has been elected been disclosed?		
235-10-50-1 to 50-6 606-10-32-2A	7.1.1	17. If the entity has elected the accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the entity's revenue-generating transactions with its customers, has the following information been disclosed: a. The fact the accounting policy has been elected? b. A description of the accounting policy? c. The method used to apply the accounting policy if such policy materially affects the balance sheet, cash flows or operating results?		

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Appendix E: Definitions

Several terms with specific meaning are used throughout this guide. Those terms and the corresponding definitions from ASC 606, ASC 610-20 and ASC 340-40 are provided in the table that follows. To the extent the term is defined in the Master Glossary of the ASC, that definition is provided.

Term	Definition
Award	The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single grantee or to a group of grantees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. References to an award also apply to a portion of an award.
Business	Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.
Cash	Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.
Cash Equivalents	Cash equivalents are short-term, highly liquid investments that have both of the following characteristics: a. Readily convertible to known amounts of cash b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).
Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Contract Asset	An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
Contract Liability	An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

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Term	Definition
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
Franchise Agreement	A written business agreement that meets the following principal criteria: a. The relation between the franchisor and franchisee is contractual, and an agreement, confirming the rights and responsibilities of each party, is in force for a specified period. b. The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area. c. Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise. The franchisor's contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, or a process. The franchisee usually contributes operating capital as well as the managerial and operational resources required for opening and continuing the franchised outlet. d. The franchise agreement outlines and describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with. e. The establishment of the franchised outlet creates a business entity that will, in most cases, require and support the full-time business activity of the franchisee. (There are numerous other contractual distribution arrangements in which a local businessperson becomes the authorized distributor or representative for the sale of a particular good or service, along with many others, but such a sale usually represents only a portion of the person's total business.) f. Both the franchisee and the franchisor have a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of the common identity within the franchisee's market area. The payment of an initial franchise fee or a continuing royalty fee is not a necessary criterion for an agreement to be considered a franchise agreement.
Franchisor	The party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.
Grant Date	The date at which a grantor and a grantee reach a mutual understanding of the key terms and conditions of a share-based payment award. The grantor becomes contingently obligated on the grant date to issue equity instruments or transfer assets to a grantee who delivers goods or renders services or purchases goods or services as a customer. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory), for example, if management and the members of the board of directors control enough votes to approve the arrangement. Similarly, individual awards that are subject to approval by the board of directors, management, or both are not deemed to be granted until all such approvals are obtained. The grant date for an award of equity instruments

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Term	Definition
	is the date that a grantee begins to benefit from, or be adversely affected by, subsequent changes in the price of the grantor's equity shares. Paragraph 718-10-25-5 provides guidance on determining the grant date. See Service Inception Date.
In Substance Nonfinancial Asset	Paragraphs 610-20-15-5 through 15-8 define an in substance nonfinancial asset.
Intangible Assets	Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.)
Joint Venture	An entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.
Lease	A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.
Legal Entity	Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.
Noncontrolling Interest	The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.
Nonprofit Activity	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.
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.

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Term	Definition
	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.
Parent	An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)
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:

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Term	Definition
	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.
Service Inception Date	The date at which the employee's requisite service period or the nonemployee's vesting period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date (see Example 6 [see paragraph 718-10-55-107] for an illustration of the application of this term to an employee award).
Standalone Selling Price	The price at which an entity would sell a promised good or service separately to a customer.
Subsidiary	An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)
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.

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Appendix F: Summary of significant changes since last edition

The following list summarizes the significant changes to this guide since our last edition. In addition to the following, references to most legacy TRG summaries and discussions were replaced with references to the FASB's RRI Q&As throughout the guide.

Chapter 1 – Executive Summary

- Section 1.15 from the prior edition, which covered the effective date of ASC 606 and ASC 340-40, was removed, as all entities have adopted the guidance.
- Section 1.16 from the prior edition, which covered the transition requirements for ASC 606 and ASC 340-40, was removed, as all entities have adopted the guidance.

Chapter 3 – Scope

- Question 3Q.1.12 was added to address whether contracts that include trade-in rights are within the scope of ASC 606.
- Section 3.3.2 was updated to remove discussion of ASC 840, as all entities have adopted ASC 842.
- Example 3-1 from the prior edition was removed and Example 3-2 and Example 3-3 from the prior edition were renumbered to Example 3-1 and Example 3-2, respectively.

Chapter 5 – Identify the contract with a customer

- Example 5-8 was updated to reflect only the post-ASC 326 content, as all entities have adopted ASC 326.

Chapter 6 – Step 2: Identify the performance obligations in the contract

- Section 6.1.2 was updated to add consideration of synthetic FOB destination arrangements and Incoterms for purposes of assessing when control of promised goods has transferred to the customer.
- Question 6Q.1.4.2 was added to address whether exclusivity provisions should be considered promised goods or services.
- Section 6.8.1 was updated to remove the discussion of legacy GAAP and ASC 606 adoption considerations for the treatment of customer cost reimbursements for NE&P activities.

Chapter 7 – Step 3: Determine the transaction price

- Question 7Q.3.3.1 was added to help clarify whether the constraint on variable consideration should be applied at the contract level or performance obligation level.
- Example 7-23, Example 7-24 and Example 7-25 were updated to reflect only the post-ASC 326 content, as all entities have adopted ASC 326.
- Question 7Q.4.3.1 was updated to reflect only the post-adoption guidance for ASU 2020-10, as all entities have adopted ASU 2020-10.
- Question 7Q.5.1.3 was added to address whether payments made to a party other than a customer could be treated as consideration payable to a customer.

Chapter 9 – Step 5: Recognize revenue when (or as) each performance obligation is satisfied

- Section 9.3.1.1 was updated to include additional considerations for a company recognizing revenue based on the right to invoice the customer.

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- Example 9-13 from the prior edition was removed, as it was duplicative of Example 10-15.
- Example 9-14 from the prior edition was removed, as it was duplicative of Example 10-16. The subsequent examples within the chapter were renumbered accordingly.
- Section 9.7.1 was updated to include additional discussion on contracts that include a forward or call option for a product that is a commodity.
- Section 9.7.1.1 was added to address contingently exercisable call options.
- Example 9-16 was updated to reflect only the post-adoption guidance for ASC 842, as all entities have adopted ASC 842.
- Example 9-19 was added to illustrate how to consider whether an arrangement to deliver goods on a fixed date meets the bill-and-hold criteria when configuration services are also provided.
- Example 9-20 was added to illustrate how to consider whether an arrangement to deliver goods on an as-requested basis along with configuration services meets the bill-and-hold criteria.
- The Spotlight on change within Section 9.9 was updated to further address fixed delivery schedules.

Chapter 10 – Licensing and rights to use

- Question 10Q.1.3 was added to address identifying performance obligations in “hybrid cloud” or “hybrid SaaS” arrangements and Question 10Q.1.3 from the prior edition was renumbered to Question 10Q.1.4.
- Section 10.3 was added to address modifications and renewals of a license of IP.

Chapter 13 – Contract costs

- Question 13Q.2.1.1.4 was added to address the treatment of capitalized commissions when a contract is modified and accounted for as if it were a termination of an existing contract.
- Question 13Q.3.1 was added to discuss how costs to obtain a contract should be capitalized and amortized when the commission payments are tiered.
- Question 13Q.3.2 was added to address whether capitalized contract costs are required to be allocated to the different performance obligations within the contract to determine the amortization period.

Chapter 14 – Presentation

- Section 14.1 and Section 14.3 were updated to reflect only the post-ASC 326 content as all entities have adopted ASC 326.

Chapter 15 – Disclosure

- Chapter 15 was updated to remove references to legacy GAAP as well as transition or adoption requirements for ASC 606 and ASC 340-40, as all entities have adopted the guidance.
- Section 15.2.3.1 was updated to address how to meet the requirements for disclosing the opening balances of accounts receivable, contract assets and contract liabilities for the earliest period presented.

Appendices

- Appendix A was updated to reflect only the post adoption guidance for ASC 842, as all entities have adopted ASC 842, and to remove Sections A.5 and A.6 from the prior edition, which addressed the effective date and transition requirements for ASC 610-20, as all entities have adopted ASC 610-20.

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- Appendix B was updated to include additional acronyms used in the guide and to replace references to most TRG summaries and discussions with references to the applicable questions within the FASB RRI Q&As.
- Appendix C and Appendix D were updated to conform with the considerations added to Section 15.2.3.1 for purposes of disclosing the opening contract balances for the earliest period presented and to remove the transition disclosure requirements, as all entities have adopted ASC 606 and ASC 340-40.
- Appendix E from the prior version was removed, as it was duplicative with our U.S. GAAP vs. IFRS comparisons white paper, which highlights the significant differences between ASC 606 and IFRS 15.
- Appendix E was added to include definitions from the Master Glossary of ASC 606, 610-20 and 340-40.

Other

- Chapter 16, Effective date, and Chapter 17, Transition, from the prior edition were removed, as all entities have adopted ASC 606 and ASC 340-40.

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A GUIDE TO REVENUE RECOGNITION

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