

Technical Line

FASB – final guidance

How the new revenue standard affects the insurance industry

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What you need to know

- ▶ Entities in the insurance industry will need to consider whether to apply the new revenue and cost guidance in ASC 606 and ASC 340-40 to contracts that are outside of the scope of ASC 944.
- ▶ Contracts that may be in the scope of ASC 606 include contracts for administrative services (e.g., claims processing) without any insurance element.
- ▶ Insurance entities that enter into warranty contracts in the scope of ASC 944 should continue to apply that guidance.
- ▶ Non-insurance entities that enter into warranty contracts (e.g., car warranties, product warranties) will need to determine whether they should account for these contracts under ASC 606 or ASC 460-10.

Overview

The new revenue recognition standard¹ issued by the Financial Accounting Standards Board (FASB or Board) became effective² for public entities for fiscal years beginning after 15 December 2017 and for interim periods therein. Nonpublic entities have to adopt the standard for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019.

The new standard, which supersedes virtually all legacy revenue guidance in US GAAP, affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements).

This publication highlights key aspects of applying the FASB's standard to arrangements entered into by entities in the insurance industry and reflects the latest implementation insights, including issues addressed by the insurance task force³ formed by the American Institute of Certified Public Accountants (AICPA).

This publication supplements our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it. The views we express in this publication may continue to evolve as implementation continues and additional issues are identified.

Scope

Contracts that are entirely in the scope of Accounting Standards Codification (ASC) 944 are outside the scope of ASC 606. These contracts include life and health insurance, property and liability insurance, title insurance and mortgage guarantee insurance, as well as certain investment contracts that do not subject an insurance entity to insurance risk from policyholder mortality or morbidity.

The Board clarified in the Background Information and Basis for Conclusions of Accounting Standards Update (ASU) 2016-20⁴ that an entity should first assess whether an entire contract is in the scope of ASC 944 before evaluating whether it should separate the contract into components that should be accounted for under ASC 944 and components that should be accounted for under ASC 606. If an insurance entity determines that a contract is not entirely in the scope of ASC 944 because a component of the contract is in the scope of ASC 606, the entity should apply the separation and measurement guidance in ASC 606-10-15-4.

Activities that fulfill a contract in the scope of ASC 944, such as insurance risk mitigation or cost containment activities, should be accounted for under ASC 944.

Examples of fulfillment activities that may be considered part of a contract in the scope of ASC 944 include:

- ▶ Claims adjudication and processing services included in an insurance contract
- ▶ Enrollment services, provider network access, routine physicals and screenings, immunizations, preventative care and wellness benefits, and transportation to facilities for treatment included in a health insurance contract
- ▶ Safety inspections performed as part of a property and liability insurance contract
- ▶ Roadside assistance provided as part of an automobile insurance policy
- ▶ Cybersecurity activities performed as part of a general liability insurance contract
- ▶ A title search provided as part of a title insurance policy

Insurance entities may offer goods or services that are not in the scope of ASC 944. For example, the Board noted⁵ that a contract for administrative services (e.g., claims processing) without any insurance element would likely be accounted for under ASC 606. The Board said⁶ the assessment of whether a contract and its components are in the scope of ASC 606 or ASC 944 is similar to the assessment of whether the contract and its components are in the scope of the legacy guidance in ASC 605 or ASC 944.

Combining contracts

If an insurance entity enters into an administrative services contract that is in the scope of ASC 606 and an insurance contract that is in the scope of ASC 944 at the same time with the same party, we believe the entity should consider the contract combination guidance in ASC 606-10-25-9. For example, the entity should determine whether the contracts were negotiated as a package with a single commercial objective, or whether there is any pricing interdependency between the contracts (e.g., whether a discount was offered on either contract) and, if so, assess whether the contracts should be combined and treated as one arrangement for accounting purposes (see Step 1 in the Appendix).

For contracts that are combined, the entity should consider the guidance discussed earlier in this section to determine whether the activities in the combined contract, other than providing insurance coverage, are predominantly performed as part of fulfilling the insurance obligation or mitigating the insurer's insurance risk. If there are elements in the combined contract that are in the scope of ASC 944 and elements in the scope of ASC 606, the entity should apply the ASC 606 guidance on separation and measurement to allocate consideration to the elements of the combined contract. Any amounts allocated to activities that are determined to be in the scope of ASC 606 should be accounted for using the remaining principles in ASC 606.

Administrative services arrangements

As a third-party administrator (TPA), a managed care organization (MCO) enters into contracts to provide health care administrative services to employers, governmental agencies, unions and other groups sponsoring self-insured plans. These contracts generally are referred to as administrative services only (ASO) plans or arrangements. While the services provided under these contracts vary, a single contract typically governs the terms and conditions of the services that an MCO must provide (i.e., the promised goods and services), which may include:

- ▶ Access to an MCO's provider networks
- ▶ Claims administration
- ▶ Customer service and monthly reporting of member activity
- ▶ Prescription benefit services
- ▶ Quality management
- ▶ Utilization management (i.e., service to help plan members maximize their benefits)
- ▶ Cost containment
- ▶ Pharmacy benefit management

Other entities also may act as TPAs and enter into similar arrangements to provide services such as processing claims, managing provider networks, performing utilization reviews or providing membership functions for another entity. The guidance discussed below should be applied to any TPA arrangement in the scope of ASC 606.

ASC 606 does apply to administrative services only plans or arrangements.

Contract duration

When applying certain aspects of ASC 606 to a contract, an entity will have to first determine the duration of the contract, which is the period in which the parties to the contract have enforceable rights and obligations. The period in which enforceable rights and obligations exist may be affected by termination provisions in the contract. That is, an entity cannot assume that there are presently enforceable rights and obligations for the entire term stated in the contract.

A typical ASO contract has a stated term of one year but can be terminated at will by either the customer or an MCO without penalty. Some ASO contracts do provide for written notice before termination (e.g., 30-day notice). In both cases, the contract term would be shorter than the stated contractual term of one year because the standard requires the performance obligations and the transaction price to be determined only for the contract duration over which the parties have present enforceable rights and obligations. Therefore, an ASO contract that can be terminated at will without penalty would be considered a daily contract, and an ASO contract that requires a 30-day written notice to terminate would be considered a monthly contract.

There also may be instances where an MCO is required to provide claims processing services beyond the contract term/cancellation date for claims made before the contract termination/cancellation date. The MCO would need to consider whether these terms extend the duration of the contract.

Identifying the performance obligations in an ASO contract

An MCO should evaluate all of the services promised in an ASO contract, including those implied by the MCO's customary business practice, to identify the separate performance obligations. Many services provided by an MCO as part of an ASO contract (e.g., network access, utilization management, claims processing) will generally represent a single performance obligation comprising a series of distinct service periods (e.g., days, months).

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer should be combined into one performance obligation (see Step 2 in the Appendix). Although the activities may vary each period, the nature of the MCO's promise to provide health care administrative services is the same each period, and these services have the same pattern of transfer.

When determining whether distinct goods or services are substantially the same, an MCO will need to first determine the nature of its promise to provide the goods or services. If the nature of its promise is to stand ready or provide a single service for a period of time, the MCO should consider in its evaluation whether each *time increment* (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same.

It is important to highlight that even if the underlying activities an MCO performs to satisfy a promise vary significantly throughout the day and from day to day, that fact, by itself, does not mean the distinct goods or services are not substantially the same. Consider Example 12A in the revenue standard, in which the nature of the promise is to provide a daily hotel management service. The service comprises activities that may vary each day (e.g., cleaning services, reservation services, property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day, and the entity is providing the same overall management service each day.

To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time if it were accounted for separately, and an MCO would have used the same method to measure the progress of transferring each distinct good or service in the series.

The Board noted in the Basis for Conclusions of ASU 2014-09⁷ that entities would not need to separately identify concurrently delivered distinct goods or services that have the same pattern of transfer as separate performance obligations because accounting for them as a single performance obligation would result in the same accounting as that of individual performance obligations.

However, certain nonroutine services, such as subrogation services, provider audits, claims reviews and other ad hoc reporting, that an MCO promises to provide in a contract should not be combined into a single performance obligation with other administrative services. That is because, while the services are distinct, they are not substantially the same and do not have the same pattern of transfer. There may be situations where other services promised by an MCO in a contract should not be combined into a single performance obligation with other promises if the promises are distinct and substantially the same, but they do not have the same pattern of transfer.

For example, an MCO may service health claims after the stated contract term for six months but will only service dental claims after the stated contract term for three months. In this situation, the entity would likely conclude that the pattern of transfer to the customer is different for the health and dental services.

In another example, an MCO that provides both administrative services for the duration of the contract and also processes health claims for an additional six months after the contract has ended would likely conclude that the two services have different patterns of transfer and therefore should be accounted for separately.

How we see it

The series provision in ASC 606 is a new concept, and we believe that entities may need to apply significant judgment when determining whether a promised good or service in a contract with a customer meets the criteria to be accounted for as a series of distinct goods or services. Entities should consider whether they need to add or make changes to their business processes or internal controls to comply with this new requirement.

Determining the transaction price

An ASO contract may contain fixed consideration such as a guaranteed minimum amount. These amounts are included in the transaction price at contract inception. However, many fees in ASO contracts are variable. For example, the fee may be based on member enrollment or activity. The standard requires an entity to estimate the amount of variable consideration to which it expects to be entitled and apply a constraint (see Step 3 in the Appendix).

Service level guarantees/clawback provisions

Some contracts with customers may provide a guarantee for a certain level of service, and if that level of service is not met, a portion of the transaction price is refunded to the customer. These service levels are generally determined over an annual period.

Consideration subject to a clawback provision like this is considered variable consideration. When estimating the amount of any clawback that could reduce the transaction price, an entity will use the most likely amount method (i.e., the single most likely amount) if it expects

to pay only one of two possible amounts (i.e., zero or the clawback amount). If there is a range of possible clawback amounts, the entity will use the expected value method (i.e., sum of probability-weighted amounts).

Since many MCOs have significant experience servicing ASO contracts and the factors that influence whether the service level guarantee is met are largely internal, an MCO may conclude that no amount of clawback should reduce the transaction price because it expects to meet the service level guarantee. However, the MCO should consider all information (i.e., historical, current and forecast) that is reasonably available when estimating variable consideration related to clawback provisions, including applying a constraint (see Step 3 in the Appendix).

Allocating the transaction price to performance obligations

After the performance obligations have been identified and the transaction price has been determined, the transaction price is generally allocated to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis).

There is one exception. ASC 606 requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations in the contract or to one or more distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation, if certain criteria are met (see Step 4 in the Appendix). The allocation of the transaction price to the performance obligations or to the distinct goods or services that form a single performance obligation will depend on the contract's facts and circumstances.

An MCO will likely apply the variable consideration allocation exception guidance and allocate variable consideration to one or more distinct services that make up a series of distinct services. This is because the variable consideration (e.g., per-member per-month fees, certain types of performance-based fees) likely meets the criteria as it relates to the entity's efforts to provide health care administrative services for a distinct period within a contract (e.g., a day, a month, a quarter), and those services are distinct from the services provided in other distinct periods within the contract. In addition, allocating the consideration in this manner is consistent with the overall allocation objective of the standard. As a result, variable consideration is allocated to those distinct periods and does not need to be estimated for purposes of recognizing revenue, except for any clawback provisions as noted above.

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

An entity must determine whether it transfers control of a promised good or service over time or at a point in time (see Step 5 in the Appendix). ASO contracts are generally satisfied over time because the customer simultaneously receives and consumes the benefits provided by an MCO as the MCO performs the service. When a performance obligation is satisfied over time, ASC 606 requires an entity to select either an input method or an output method of measuring progress for each performance obligation that depicts the entity's performance in transferring control of goods or services to the customer. An MCO may determine that time elapsed (which could be an input method or an output method) best depicts its performance in transferring control of health care administrative services to the customer.

When an MCO applies an output method, it can elect to use a practical expedient that allows it to recognize revenue in the amount to which the entity has a right to invoice if that consideration corresponds directly with the value to the customer of the entity's performance completed to date (e.g., in a service contract in which an entity bills a fixed amount for each hour of service provided).

Contract costs

Costs to obtain a contract

Under the new cost guidance in ASC 340-40,⁸ incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. Entities may determine that commissions paid to employees or third-party brokers that are related to obtaining a customer contract may require capitalization. These costs should not be limited to initial incremental costs. Because ASC 606 does not explicitly address different types of commission programs, insurance entities will have to exercise judgment to determine whether sales commissions are incremental costs and, if they are, determine the point in time when they should be capitalized.

For example, an entity will need to carefully consider commissions that are paid to supervisors and commissions that are not directly linked to any single contract (e.g., commissions based on reaching a specified level of sales). Commissions recognized after contract inception (e.g., commissions paid on contract renewals, commissions subject to contingent events or clawback) also should be considered for capitalization as costs to obtain the contract when the liability is recognized.

ASC 606 provides a practical expedient permitting entities to immediately expense contract acquisition costs when the asset resulting from the capitalization of these costs would have been amortized in one year or less (see Contract costs in the Appendix).

Any capitalized costs to obtain a contract will be amortized, with the expense recognized as an entity transfers the related goods or services, including goods or services provided under a specific anticipated contract to the customer. Entities should consider any expected renewal commissions when determining the amortization period.

How we see it

The requirement to capitalize certain costs of obtaining a contract with a customer could change practice for some entities. Commissions paid for obtaining a new contract or customer, for example, may need to be capitalized, amortized and reviewed regularly for impairment. This could require additional record-keeping.

Costs to fulfill a contract

Entities will continue to follow the guidance in other Codification topics for costs incurred to fulfill a contract (e.g., internal-use software in the scope of ASC 350-40). If these costs aren't in the scope of other guidance, an entity is required under ASC 606 to recognize an asset for the costs incurred to fulfill a contract only if those costs meet certain criteria (see Contract costs in the Appendix). The standard also states that costs relating to fully or partially satisfied performance obligations in a contract (i.e., costs that relate to past performance) are expensed as incurred.

Entities will need to evaluate whether costs incurred to provide services (e.g., travel, meals) and other general fulfillment costs (e.g., salaries paid to employees) can be capitalized as costs to fulfill a contract. The costs for providing health care administrative services likely will not generate or enhance resources that the entity will use in satisfying performance obligations in the future and therefore should not be capitalized. Once an entity has begun satisfying a performance obligation over time (e.g., providing health care administrative services), it should only capitalize costs that relate to future performance.

Entities may need to capitalize commissions that relate to obtaining a customer contract.

In certain situations, an entity may enter into a contract to provide services that will require it to perform setup activities such as setting up a system to process claims, for which it may receive compensation. The entity needs to evaluate whether the setup activities are a separate performance obligation (i.e., whether those activities transfer control of a promised good or service to the customer). Entities should consider the definition of control, which requires an entity to have the ability to direct the use of and obtain substantially all of the remaining benefits of an asset. In many cases, the setup activities do not transfer a promised good or service to the customer. If an entity determines that setup activities do not transfer a promised good or service to the customer, it would capitalize the costs incurred (if all the criteria for capitalization are met under ASC 340-40-25-5) and include the fees it receives in the transaction price, which it would allocate and recognize as discussed above.

Any capitalized costs to fulfill a contract will be amortized, with the expense recognized as the entity transfers the related goods or services to the customer.

Warranties

An insurance entity that enters into warranty contracts in the scope of ASC 944 should continue to apply that guidance. A non-insurance entity that enters into warranty contracts (e.g., car warranty, product warranty) should evaluate whether the contracts should be accounted for under ASC 606 or ASC 460-10.⁹

If the customer does not have the option to purchase the warranty separately and the warranty does not provide a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing an assurance-type warranty that should be accounted for under ASC 460-10. Otherwise, it is a service-type warranty that should be accounted for under ASC 606.

A service-type warranty provides an additional, distinct service and is a separate performance obligation. Therefore, an entity allocates a portion of the transaction price to the service-type warranty based on the estimated standalone selling price of the warranty. The entity then recognizes revenue allocated to the warranty over the period the warranty service is provided because the customer will likely receive and consume the benefits of the warranty as the entity performs (i.e., the warranty performance obligation is likely satisfied over time in accordance with ASC 606-10-25-27(a)). Judgment may be required to determine the appropriate period over which the performance obligation is satisfied and the pattern of revenue recognition. An entity should consider the nature of its performance obligation, as well as its historical experience, when determining the appropriate period over which to recognize revenue.

Measure of progress

If an entity determines that it is providing protection against damage, loss or malfunction of a product caused by various perils for the specified coverage period (i.e., provides assurance of use for the product that would include some level of involvement with the repair or replacement), it should recognize revenue over the coverage period.

If an entity determines that it has to fix, arrange to fix or replace the product (i.e., provides an unknown quantity of services for a fixed fee), it should recognize revenue over the period in which it is expected to replace or repair the product. The period could extend beyond the coverage period if services to repair or replace the product are expected to be provided after the coverage period ends. For example, a claim may be filed at the end of a one-year period but is fulfilled after the coverage period ends. While the activities in both instances may be similar, the nature of the promise to the customer determines the period of recognition.

How we see it

Under ASC 606, if an entity determines that the nature of its promise is to fix, arrange to fix or replace a product under warranty, the entity may determine that the period of revenue recognition may be beyond the stated coverage period. This is different from insurance entities that recognize premiums over the stated coverage period in accordance with ASC 944.

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer (e.g., a product warranty or a car warranty that is fulfilled by a third party), the entity should determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. If the entity controls a promised good or service before transferring that good or service to the customer, it is a principal and therefore records revenue on a gross basis. An entity is an agent and records as revenue the net amount it retains for its agency service if its role is to arrange for another entity to provide the goods or services. Significant judgment may be required to determine whether an entity is a principal or an agent in a contract with a customer.

There may be situations where an entity is a principal but does not know (and does not expect to know) the price an intermediary charges its customer for its goods and services. In those instances, the principal should not estimate its gross transaction price. The Board stated in the Basis for Conclusions of ASU 2016-08¹⁰ that if uncertainty related to the transaction price is not ultimately expected to be resolved, the price the intermediary charges to the customer would not meet the definition of variable consideration and therefore should not be included in the transaction price.

Disclosures

While service-type warranties are accounted for under ASC 606 and an entity is required under ASC 606-10-50-12(e) to disclose information about types of warranties and related obligations, the product warranty disclosures required under ASC 460-10-50-8 also apply to service-type warranties, including:

- The nature of the guarantee (i.e., the warranty), including the approximate term of the warranty, how the warranty arose, the events or circumstances that would require the entity to perform under the warranty and the current status (i.e., as of the date of the statement of financial position) of the payment/performance risk of the warranty
- The nature of any recourse provisions that would enable the entity to recover from third parties any of the amounts paid under the warranty
- The entity's accounting policy and methodology used in determining its liability for product warranties
- A tabular reconciliation of the changes in the entity's aggregate product warranty liability for the reporting period

The tabular reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates) and the ending balance of the aggregate product warranty liability.

Service-type warranties accounted for under ASC 606 also have to provide the disclosures required under ASC 460-10.

Endnotes:

- ¹ Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, was created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, and various amendments.
- ² Under US GAAP, public entities, as defined, were required to adopt the standard for annual reporting periods beginning after 15 December 2017 (1 January 2018, for calendar-year public entities), and interim periods therein. Nonpublic entities are required to adopt the standard for annual reporting periods beginning after 15 December 2018, and interim periods within annual reporting periods beginning after 15 December 2019. Public and nonpublic entities were permitted to adopt the standard as early as annual reporting periods beginning after 15 December 2016. Public entities that elected to early adopt the standard were required to adopt the standard in the first interim period of an annual period.
- ³ The AICPA formed 16 industry task forces to help develop a new accounting guide on revenue recognition and to aid industry stakeholders in implementing the standard.
- ⁴ Paragraph BC15 of ASU 2016-20.
- ⁵ Paragraph BC14 of ASU 2016-20.
- ⁶ Paragraph BC15 of ASU 2016-20.
- ⁷ Paragraph BC115 of ASU 2014-09.
- ⁸ ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, was created by ASU 2014-09.
- ⁹ ASC 460-10, *Guarantees – Overall*.
- ¹⁰ Paragraph BC38 of ASU 2016-08.

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Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that will require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer
<p>Definition of a contract</p> <p>An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:</p> <ul style="list-style-type: none"> ▶ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations. ▶ The entity can identify each party's rights regarding the goods or services to be transferred. ▶ The entity can identify the payment terms for the goods or services to be transferred. ▶ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract). ▶ It is probable that the entity will collect 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. <p>If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.</p> <p>Contract combination</p> <p>The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:</p> <ul style="list-style-type: none"> ▶ The contracts are negotiated as a package with a single commercial objective. ▶ The amount of consideration to be paid in one contract depends on the price or performance of another contract. ▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation. <p>Contract modifications</p> <p>A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:</p> <ul style="list-style-type: none"> ▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract. ▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract. ▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

Step 2: Identify the performance obligation(s) in the contract

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

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

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities will need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted.
- ▶ One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract.
- ▶ If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Series guidance

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

Customer options for additional goods or services

A customer's option to acquire additional goods or services for free or at a discount is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its

role is to arrange for another entity to provide the goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

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

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

Variable consideration

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

Significant financing component

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

Noncash consideration

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

Consideration paid or payable to the customer

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, and credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service.
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.
- ▶ The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- ▶ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

Licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either:

- ▶ A right to access the entity's IP throughout the license period (a right to access)
- ▶ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use)

To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories:

- ▶ **Functional:** This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time.
- ▶ **Symbolic:** This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP.

The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).

Contract costs

ASC 340-40 specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify.
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- ▶ The costs are expected to be recovered.

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment at the end of each reporting period.