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Technical Line

FASB — final guidance

A closer look at the new revenue recognition standard

What you need to know

- The new revenue standard creates a single source of revenue guidance for all companies in all industries. This is a significant change from today's guidance, which contains many pieces of industry- or transaction-specific literature.
- The new standard is more principles-based than current revenue guidance and lacks some of the complexity and specificity of the current guidance. The lack of bright lines will result in the need for increased judgment.
- While the new guidance will have little effect on some entities, it will significantly change the accounting for others, especially entities that follow today's industry- or transaction-specific guidance.
- The new standard also addresses the accounting for items not typically thought of as revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain nonfinancial assets.
- We are just beginning to understand the new standard and how it will be applied in practice. As we learn more, we will issue updated guidance to provide additional implementation insights.

Overview

The Financial Accounting Standards Board (the FASB) and the International Accounting Standards Board (the IASB) (collectively, the Boards) have jointly issued a new revenue recognition standard that will supersede virtually all revenue recognition guidance in US GAAP and IFRS.

Noting several concerns with existing guidance on revenue recognition for both US GAAP and IFRS, the Boards decided to develop a joint revenue standard that would:

- Remove inconsistencies and weaknesses in the current revenue recognition literature
- Provide a more robust framework for addressing revenue recognition issues
- Improve comparability of revenue recognition practices across industries, entities within those industries, jurisdictions and capital markets
- Reduce the complexity of applying revenue recognition guidance by reducing the volume of the relevant guidance
- Provide more useful information to investors through new disclosure requirements

The new standard provides accounting guidance for all revenue arising from contracts with customers and 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, such as the leasing literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate.

As a result, the standard will likely affect an entity's financial statements, business processes and internal control over financial reporting. While some companies will be able to implement the new standard with limited effort, others may find implementation to be a significant undertaking. An early assessment will be the key to managing implementation.

While the Boards actually issued two separate standards, we refer to them in this publication as a single standard. The standards under US GAAP and IFRS are identical except for these areas: (1) the Boards used the term "probable" to describe the level of confidence needed when assessing collectibility to identify contracts with customers, which will result in a lower threshold under IFRS than US GAAP; (2) the FASB required more interim disclosures than the IASB; (3) the IASB allows early adoption; (4) the FASB does not allow reversals of impairment losses and the IASB does; and (5) the FASB provides relief for nonpublic entities relating to specific disclosure requirements, the effective date and transition.

The guidance outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize 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.

The principles in the new standard will be applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

An entity will need to exercise judgment when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of the new standard consistently to contracts with similar

characteristics and in similar circumstances. In response to feedback received, the Boards included more examples in the final guidance than they had in the proposal. We included a list of these examples in Appendix C to this publication.

The new guidance must be adopted using either a full retrospective approach for all periods presented in the period of adoption (with some limited relief provided) or a modified retrospective approach. The effective date for US GAAP followers is fiscal years beginning after 15 December 2016 for public entities or 15 December 2017 for nonpublic entities. It is important to note that the FASB defined public entities for purposes of this standard more broadly than just entities that have publicly traded equity or debt. See Section 1.1.1 for more discussion on this topic. IFRS preparers must adopt the standard for fiscal years beginning on or after 1 January 2017. Early adoption is permitted for entities that report under IFRS but not for public entities that report under US GAAP.

This publication highlights key aspects of the new revenue recognition model. In the coming weeks, we also will issue industry-specific publications that will address, in further detail, significant changes to current industry practice. We encourage preparers and users of financial statements to read this publication and the industry supplements carefully and consider the potential effects of the new model.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will issue updated guidance to provide the latest implementation insights.

Contents

1 Effective date and transition 6
1.1 Effective date 6
1.2 Transition approach 8
1.3 Application considerations 14
2 Scope 16
2.1 Definition of a customer 16
2.2 Collaborative arrangements 17
2.3 Interaction with other guidance 18
3 Identify the contract with the customer 20
3.1 Attributes of a contract 20
3.2 Combining contracts 25
3.3 Contract modifications 25
3.4 Arrangements that do not meet the definition of a contract under the standard 32
4 Identify the performance obligations in the contract 35
4.1 Identifying the promised goods and services in a contract 35
4.2 Separate performance obligations 38
4.3 Goods and services that are not distinct 44
4.4 Principal versus agent considerations 45
4.5 Consignment arrangements 49
4.6 Customer options for additional goods or services 50
4.7 Sale of products with a right of return 51
5 Determine the transaction price 53
5.1 Variable consideration 54
5.2 Accounting for specific types of variable consideration 64
5.3 Significant financing component 67
5.4 Noncash consideration 71
5.5 Consideration paid or payable to a customer 73
5.6 Nonrefundable up-front fees 77
6 Allocate the transaction price to the performance obligations 78
6.1 Estimating standalone selling prices 78
6.2 Applying the relative standalone selling price method 85
6.3 Allocating variable consideration 86
6.4 Allocating a discount 90
6.5 Changes in transaction price after contract inception 93
6.6 Allocation of transaction price to elements outside the scope of the standard 93

7 Satisfaction of performance obligations ... 95
7.1 Performance obligations satisfied over time ... 95
7.2 Control transferred at a point in time ... 107
7.3 Repurchase agreements ... 111
7.4 Bill-and-hold arrangements ... 116
7.5 Customer acceptance ... 118
7.6 Licensing and rights to use ... 120
7.7 Recognizing revenue when a right of return exists ... 120
7.8 Breakage and prepayments for future goods or services ... 120
7.9 Loss contracts ... 122

8 Other measurement and recognition topics ... 123
8.1 Warranties ... 123
8.2 Loss contracts ... 126
8.3 Contract costs ... 127
8.4 Licenses of intellectual property ... 133

9 Presentation and disclosure ... 143
9.1 Presentation — Contract assets, contract liabilities and revenue ... 143
9.2 Disclosures ... 144
9.3 Disclosures for public entities ... 146
9.4 Disclosure for nonpublic entities ... 155

10 Implementation considerations ... 162
10.1 Not just an accounting change ... 162
10.2 Implementing accounting change ... 163
10.3 Assessment phase ... 163
10.4 Remaining implementation effort ... 168
10.5 Communicate with key stakeholders ... 168

Appendix A: Disclosure checklist — Public entities ... 170

Appendix B: Disclosure checklist — Nonpublic entities ... 174

Appendix C: Illustrative examples included in standard ... 176

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1 Effective date and transition

1.1 Effective date

The new standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. Early adoption is not permitted for public entities. Nonpublic entities are required to adopt the new guidance for fiscal years beginning after 15 December 2017, and interim periods within fiscal years beginning after 15 December 2018, and may adopt it as early as the public entity effective date (see Section 1.1.2).

1.1.1 Definition of a 'public' entity

The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following:

- A public business entity (PBE).
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market.
- An employee benefit plan that files or furnishes financial statements with the SEC.

Accounting Standards Update (ASU) 2013-12, *Definition of a Public Business Entity,* states that a business entity is a public business entity if it meets any of the following criteria:[1]

- "(a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion."

1.1.2 Nonpublic entities

An entity that does not meet any of the criteria above is considered a nonpublic entity for purposes of this standard. A nonpublic entity may elect to apply this guidance earlier in any of the following manners:

- For annual reporting periods beginning after 15 December 2016, including interim periods therein (i.e., following the effective date for public entities)
- For annual reporting periods beginning after 15 December 2016 and interim and annual reporting periods thereafter

1.1.3 *Effective date for public and nonpublic entities*

Although early adoption is not allowed under US GAAP (with the exception of allowing nonpublic entities to elect an effective date as early as public entities), it is permitted under IFRS. As a result, entities applying IFRS could adopt the new revenue guidance as soon as the standard is issued.

The table below illustrates the effective date of the new guidance for public and nonpublic entities following US GAAP with differing fiscal year-ends.

Year-end	Mandatory adoption date		Options for early adoption for Nonpublic entities only
	Public	**Nonpublic**	
31 December	1 January 2017 effective date, first present in 31 March 2017 Form 10-Q	1 January 2018 effective date, first present in the financial statements for the year ended 31 December 2018	▸ 1 January 2017 effective date, first present in 31 March 2017 interim financial statements OR ▸ 1 January 2017 effective date, first present in the financial statements for the year ended 31 December 2017 OR ▸ 1 January 2018 effective date, first present in 31 March 2018 interim financial statements
31 March	1 April 2017 effective date, first present in 30 June 2017 Form 10-Q	1 April 2018 effective date, first present in the financial statements for the year ended 31 March 2019	▸ 1 April 2017 effective date, first present in 30 June 2017 interim financial statements OR ▸ 1 April 2017 effective date, first present in the financial statements for the year ended 31 March 2018 OR ▸ 1 April 2018 effective date, first present in 30 June 2018 interim financial statements
30 June	1 July 2017 effective date, first present in 30 September 2017 Form 10-Q	1 July 2018 effective date, first present in the financial statements for the year ended 30 June 2019	▸ 1 July 2017 effective date, first present in 30 September 2017 interim financial statements OR ▸ 1 July 2017 effective date, first present in the financial statements for the year ended 30 June 2018 OR ▸ 1 July 2018 effective date, first present in 30 September 2018 interim financial statements
30 September	1 October 2017 effective date, first present in 31 December 2017 Form 10-Q	1 October 2018 effective date, first present in the financial statements for the year ended 30 September 2019	▸ 1 October 2017 effective date, first present in 31 December 2017 interim financial statements OR ▸ 1 October 2017 effective date, first present in the financial statements for the year ended 30 September 2018 OR ▸ 1 October 2018 effective date, first present in 31 December 2018 interim financial statements

How we see it

Because the standard applies to PBEs, certain non-issuer entities will likely be required to adopt the new guidance sooner than they may have anticipated. That is because the definition of a PBE is broader than other definitions of public entities and publicly traded companies in US GAAP, and determining whether an entity is a PBE may require assistance from legal counsel. For example, it includes entities whose financial statements or financial information is furnished or filed in another entity's SEC filing.

These entities also will have to make public company disclosures that are more extensive than those for nonpublic entities. See Section 9 for further discussion.

1.2 Transition approach

The new revenue standard requires retrospective application. However, the Boards decided to allow either a "full retrospective" adoption in which the standard is applied to all of the periods presented or a "modified retrospective" adoption.

For purposes of applying the transition requirements, the Boards clarified the following terms:

- The date of initial application — the start of the reporting period in which an entity first applies the new guidance. For example, for a public entity with a fiscal year-end of 31 December, the date of initial application will be 1 January 2017.
- Completed contract — a contract in which the entity has fully transferred all of the identified goods and services before the date of initial application. As a result, entities won't have to apply the new standard to arrangements if they have completed performance before the date of initial application, even if they have not yet received consideration and that consideration may still be subject to variability.

1.2.1 Full retrospective adoption

Entities electing full retrospective adoption will apply the standard to each period presented in the financial statements in accordance with the accounting changes guidance in Accounting Standards Codification (ASC) 250-10-45-5 through 45-10,[2] subject to the practical expedients created to provide relief, as discussed below. This means entities will have to apply the new guidance as if it had been in effect since the inception of all its contracts with customers presented in the financial statements. During deliberations, the Boards seemed to prefer the full retrospective approach under which all contracts with customers are recognized and measured consistently in all periods presented within the financial statements, regardless of contract inception. This approach also provides users of the financial statements with useful trend information across all periods presented.

However, to ease the potential burden of a full retrospective application, the Boards provided the following relief:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Transition and Open Effective Date Information

Transition Related to Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606)

606-10-65-1

(d) An entity shall apply the pending content that links to this paragraph using one of the following two methods:

1. Retrospectively to each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10 subject to the expedients in (f).

2. Retrospectively with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the date of initial application in accordance with (h) through (i).

(e) If an entity elects to apply the pending content that links to this paragraph retrospectively in accordance with (d)(1), the entity shall provide the disclosures required in paragraphs 250-10-50-1 through 50-3 in the period of adoption.

(f) An entity may use one or more of the following practical expedients when applying the pending content that links to this paragraph retrospectively in accordance with (d)(1):

1. For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period.

2. For completed contracts that have variable consideration, an entity may use the **transaction price** at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining **performance obligations** and an explanation of when the entity expects to recognize that amount as revenue (see paragraph 606-10-50-13).

Entities can elect to apply none, some or all of these expedients. However, if an entity elects to use any of them, it must apply that expedient consistently to all contracts within all periods presented. In other words, it would not be appropriate to apply the selected expedient to some but not all of the periods presented. Entities that choose to use some or all of the relief will be required to provide additional qualitative disclosures (i.e., which types of relief the entity applied and the likely effects of that application).

An entity that elects to apply the guidance retrospectively must also provide the disclosures required in ASC 250-10-50-1 through 50-3, as follows.

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections — Overall

Disclosure

Change in Accounting Principle

250-10-50-1

An entity shall disclose all of the following in the fiscal period in which a **change in accounting principle** is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

1. A description of the prior-period information that has been retrospectively adjusted, if any.

2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

4. If **retrospective application** to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If **indirect effects of a change in accounting** principle are recognized both of the following shall be disclosed:

1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable.

2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

250-10-50-2

An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

250-10-50-3

In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.

ASC 250-10-50-1 requires these disclosures to be made by an entity in the fiscal period in which a change in accounting principle is made.

Financial statements of subsequent periods need not repeat the required disclosures initially made in the period of an accounting change. However, entities that issue interim financial statements must provide the required disclosures in the financial statements of both the interim and annual periods that include the direct or indirect effects of a change in accounting principle. For example, a public entity that makes a change in accounting principle in the first quarter of 20X7 must include the required disclosures in its first-, second- and third-quarter interim financial statements. The entity must also include the required disclosures for the annual period in its annual financial statements for 20X7. These disclosures are not required in the financial statements for any interim or annual periods after 20X7.

ASC 250-10-50-3 requires that in the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for the post-change interim periods. That is, for subsequent interim periods in the fiscal year of an accounting change, an entity must determine and disclose the amounts that would have been reported under the "old" accounting principle had it not made the accounting change. For the indirect effects of a change in accounting principle, an entity is required to disclose a description of the indirect effects, the amounts recognized in the current period and the related per-share amounts, as well as, if practicable, the total recognized indirect effects of the accounting change and the related per-share amounts attributable to each prior period presented.

1.2.2 Modified retrospective application

Entities that elect the modified retrospective approach will apply the guidance retrospectively only to the most current period presented in the financial statements. To do so, the entity will have to recognize the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) at the date of initial application.

Under this approach, the new revenue standard will be applied to contracts that are in progress at the date of initial application (e.g., 1 January 2017 for an entity with a 31 December year-end). That is, contracts that are not completed before the date of initial application will have to be evaluated as if the entity had applied the new standard to these arrangements since inception of the arrangement. Under this approach, an entity will:

- Present comparative periods under today's guidance
- Apply the new revenue standard to new and existing contracts as of the effective date
- Recognize a cumulative catch-up adjustment to the opening balance of retained earnings at the effective date for existing contracts that still require performance by the entity
- In the year of adoption, disclose the amount by which each financial statement line item was affected as a result of applying the new standard and an explanation of significant changes

How we see it

Depending on an entity's prior accounting, applying the modified retrospective approach may be more difficult than the entity anticipates. Entities may encounter situations that likely will make this application more complex, including:

- The distinct performance obligations identified under the new guidance are different from the separate units of accounting identified under today's guidance.

- The relative selling price allocation under the new guidance results in different amounts being allocated to distinct performance obligations than had been allocated in the past.
- The arrangement contains variable consideration, and the amount of variable consideration that can be included in the allocable consideration differs from the amount under today's guidance.

Entities should also consider that the modified retrospective approach effectively requires an entity to keep two sets of accounting records in the year of adoption in order to comply with the requirement to disclose all line items in the financial statements as if they were prepared under today's guidance.

The following example illustrates the potential effects of modified retrospective adoption:

Illustration 1-1 Cumulative effect of adoption under modified retrospective

A public entity software vendor with a 31 December fiscal year-end adopts the new revenue recognition guidance as of 1 January 2017. The vendor selects the modified retrospective approach for adoption.

The vendor frequently enters into arrangements to provide a software license, professional services and post-contract support (PCS), and previously accounted for its arrangements in accordance with ASC 985-605.[3] Further, the vendor did not have vendor-specific objective evidence (VSOE) of the fair value for the PCS and, as a result, recognized the arrangement consideration ratably over the PCS period.

Under the new guidance, the vendor would likely reach a different conclusion regarding the units of account than it did under ASC 985-605 because the standard does not require VSOE of fair value to treat promised goods and services as distinct performance obligations (discussed further in Section 4.2 of this publication).

As a result, the vendor's analysis of contracts in progress as of 1 January 2017 would likely result in the identification of different distinct performance obligations from those it previously used for revenue recognition. As part of this assessment, the entity would need to allocate the estimated transaction price based on the relative standalone selling price method (see Section 6.2 of this publication) to the newly identified distinct performance obligations.

The vendor would compare the revenue recognized for each arrangement from contract inception through 31 December 2016 to the amount that would have been recognized if it had applied the new standard since contract inception. The difference between those amounts would be accounted for as a cumulative effect adjustment and recognized on 1 January 2017. Beginning on 1 January 2017, the amount of revenue recognized would be based on the new guidance.

An entity that elects to apply the modified retrospective approach will be required to make certain additional disclosures in the year of initial application, including interim periods. Specifically, the entity must disclose the amount by which each financial statement line item is affected as a result of applying the new standard. Further, an entity must disclose a qualitative explanation of the significant changes between the reported results under the new revenue recognition standard and the prior revenue recognition guidance.

1.2.3 *Additional consideration for public entities*

Public entities also will have to consider their presentation of the selected financial data table.[4] The SEC staff's longstanding view has been that all periods in the five-year table must be recast to give effect to the retrospective adoption of a new accounting standard or change in accounting principle. As of our publication date, the SEC staff had not responded to questions

about whether it will provide relief from this requirement for entities that apply the full retrospective approach for this standard. A registrant's decision about which transition method to apply may hinge on the SEC staff's answer, given that restating the additional periods may be a significant burden. Registrants that choose the modified retrospective approach would disclose in a note to the table of selected financial data, or in a cross-referenced discussion, accounting changes that materially affect comparability among the years presented.

In addition, entities that select full retrospective application should be aware that adopting a new accounting standard can materially affect the financial statement requirements for SEC registration statements that are filed or become effective following the first Form 10-Q reflecting the adoption of the new standard. The filing or post-effective amendment of a Form S-3 requires recast annual financial statements if there has been a change in accounting principle that requires a material retrospective restatement of financial statements. Item 11(b) of Form S-3 would require a registrant to recast its prior-period annual financial statements that are included or incorporated by reference in the registration statement to reflect the retrospective application of the new standard, if the effect is material. Similar considerations would apply to a Form S-1 when historical financial statements are incorporated by reference. The recast financial statements (with accompanying management's discussion and analysis (MD&A) and selected financial data) generally are filed in a Form 8-K and not an amended Form 10-K because the original financial statements did not contain errors.

Entities also need to begin providing disclosures about the effects of recently issued accounting standards in registration statements and periodic reports filed with the SEC. SEC Staff Accounting Bulletin (SAB) Topic 11.M[5] requires disclosure of the potential effects of recently issued accounting standards, to the extent that those effects are known. Companies should consider the following disclosures within MD&A and the financial statements:

- A brief description of the new standard, the date that adoption is required and, for registrants applying IFRS, the date that the registrant plans to adopt, if earlier
- A discussion of the methods of adoption allowed by the standard and the method the registrant expects to use, if determined
- A discussion of the effect the standard is expected to have on the financial statements or, if the effect isn't known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)

How we see it

Initially, we anticipate companies may not know or be able to make a reasonable estimate of the effect the new standard will have on its financial statements and will make a statement to that effect. For example, a company may note the following:

> In May 2014, the FASB issued guidance codified in ASC 606, *Revenue Recognition — Revenue from Contracts with Customers*, which amends the guidance in former ASC 605, *Revenue Recognition*. The Company is currently evaluating the impact of the provisions of ASC 606.

We note that the SEC staff expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available. Entities should disclose their expected transition method once decided.

As a reminder, for purposes of providing financial information of significant equity method investees under Rules 3-09 and 4-08(g) of Regulation S-X, a period that was once insignificant could become significant because of a retrospective accounting change. A registrant does not need to remeasure significance in any registration statement or proxy statement filed in the current fiscal year. However, when the registrant files its next Form 10-K, it must recalculate significance for each fiscal year presented using the historical financial statements that are retrospectively revised for the accounting change. Depending on the level of significance based on the revised calculation, separate audited financial statements or summarized financial information of the equity method investee could be required.

Public entities will also have to consider whether their implementation of new controls and processes related to adoption of the new standard requires disclosure about material changes in internal control over financial reporting under Item 308(c) of Regulation S-K.

1.3 Application considerations

Regardless of the transition model selected, many entities will have to apply the new guidance to arrangements they entered into in prior periods. The population of contracts will be larger under the full retrospective approach; however, under the modified retrospective approach, entities will have to apply the new guidance to all contracts that are in process as of the initial application date, regardless of contract inception. Questions on the mechanics of retrospective application are likely to arise.

In addition, while the Boards provided some relief from a full retrospective approach and provided the option of a modified retrospective approach, the Boards still haven't addressed a number of implementation issues that may make applying the new standard difficult and time consuming.

For example:

- In the case of a full retrospective adoption, entities likely will be required to perform a relative standalone selling price allocation because of changes to the identified units of account, the transaction price or both. If an entity previously performed a relative selling price allocation (e.g., when the transaction was accounted for under ASC 605-25, *Revenue Recognition — Multiple-Element Arrangements*), this step will likely be straightforward. However, if an entity didn't previously perform a relative selling price allocation, an entity will be required to determine the standalone selling price of each distinct performance obligation as of contract inception. Depending on the age of the contract, this information may not be readily available, and the prices may differ significantly from current standalone selling prices. While the standard is clear on when it is acceptable to use hindsight when considering variable consideration for purposes of determining the transaction price (see Section 5.1), the standard is silent on whether the use of hindsight is acceptable for other aspects of the model (e.g., for purposes of allocating the transaction price) or whether it would be acceptable to use current pricing information if that were the only information available.

- Estimating variable consideration for all contracts for the prior periods will likely require significant judgment. The standard states that hindsight cannot be used for contracts in-progress when applying the full retrospective method. While the standard is silent on whether the use of hindsight is acceptable for entities applying the modified retrospective approach, the Boards' discussion in the Basis for Conclusions implies that there are no practical expedients available for the modified retrospective approach. Further, since entities applying the modified retrospective approach will only be adjusting contracts in-progress, it seems likely that the use of hindsight is not acceptable. As a result, entities must make this estimate based only on information that was available at contract

inception. Contemporaneous documentation clarifying what information was available to management and when will likely be needed to support these estimates. In addition to estimating variable amounts using the expected value or a most likely amount approach, entities will have to make conclusions about whether such variable amounts are subject to the constraint (see Section 5.1 for further discussion).

- The modified retrospective approach doesn't require entities to recast the amounts reported in prior periods, but entities electing this approach will still have to calculate, as of the adoption date for any open contracts, the revenues they would have recognized if they had applied the new guidance since contract inception to determine the cumulative effect of adopting the new standard. This is likely to be most challenging for arrangements for which the unit of account or allocable arrangement consideration changes when the new guidance is applied.

Finally, entities will need to consider a number of other issues as they prepare to adopt the new standard. For example, entities with significant deferred revenue balances prior to implementation may experience "lost revenue" as those amounts either become prior-year revenue amounts or are included in the cumulative effect adjustment. See Section 10 for further discussion of some of the more significant implementation considerations.

2 Scope

The scope of the new guidance includes all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts that are specifically excluded from the scope:

- Lease contracts within the scope of ASC 840[6]
- Insurance contracts within the scope of ASC 944[7]
- Financial instruments and other contractual rights or obligations (e.g., receivables, debt and equity securities, derivatives)[8]
- Guarantees (other than product or service warranties) within the scope of ASC 460[9]
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange[10]

For certain arrangements, entities will have to evaluate their relationship with the counterparty to the contract to determine whether a vendor-customer relationship exists. For example, some collaboration arrangements are more akin to a partnership, while others have a vendor-customer element. Only arrangements that are determined to be with a customer are within the scope of the new standard. See Section 2.2 for a discussion of collaborative arrangements.

Certain agreements executed by entities include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the same or similar goods in the original agreement. The form of the repurchase agreement and whether the customer obtains control of the asset subject to the agreement will determine whether the agreement is within the scope of the new standard. See Section 7.3 for a discussion on repurchase agreements.

Entities may enter into transactions that are partially within the scope of the new revenue recognition guidance and partially within the scope of other guidance. In these situations, the new guidance requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard. See Section 2.3 for further discussion on this topic.

2.1 Definition of a customer

The new guidance defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." In many transactions, a customer is easily identifiable. However, in transactions involving multiple parties, it is less clear which counterparties are customers of the entity. For some arrangements, multiple parties could all be considered customers of the entity. However, for other arrangements, only some of the parties involved are considered customers. The illustration below shows how the party considered to be the customer may differ, depending on the arrangement. As discussed further in Section 4.1, the identification of the performance obligations in an arrangement can have a significant effect on the determination of which party is the entity's customer in the arrangement.

The new standard does not define the term "ordinary activities" because it was derived from existing guidance. Under today's guidance, CON 6[11] refers to ordinary activities as an entity's "ongoing major or central operations."

Illustration 2-1: Identification of a customer

An entity provides internet-based advertising services to companies. As part of that service, the entity obtains banner space on various websites from a selection of publishers. For certain arrangements, the entity provides a sophisticated service of matching the ad placement with the pre-identified criteria of the advertising party. In addition, the entity purchases the advertising space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the principal in these arrangements (see Section 4.4 for further discussion on this topic). Based on this conclusion, the entity determines that its customer in this transaction is the advertiser, and gross revenue will be recognized as the sophisticated advertising services are provided.

In other arrangements, the entity simply matches advertisers with the publishers in its portfolio, but the entity does not provide any ad-targeting services. Assume that the entity appropriately concludes it is acting as the agent in these arrangements. Based on this conclusion, the entity determines that its customer is the publisher, and net revenue will be recognized as those agency services are provided to the publisher.

2.2 Collaborative arrangements

In certain transactions, a counterparty may not always be a "customer" of the entity. Instead, the counterparty may be a collaborator or partner that shares in the risks and benefits of developing a product to be marketed. These transactions, which are common in the pharmaceutical, biotechnology, oil and gas, and health care industries, generally are in the scope of ASC 808, *Collaborative Arrangements*. However, depending on the facts and circumstances, these arrangements may also contain a vendor-customer aspect. Such contracts could still be within the scope of the new revenue guidance, at least partially, if that collaborator or partner meets the definition of a customer for some or all aspects of the arrangement.

The Boards decided not to provide further guidance for determining whether certain revenue-generating collaborative arrangements would be in the scope of the new guidance. In the Basis for Conclusions, the Boards explain that it would not be possible to provide implementation guidance that applies to all collaborative arrangements. Therefore, the parties to such arrangements need to consider all of the facts and circumstances to determine whether a vendor-customer relationship exists that is subject to the new guidance.

However, the Boards did determine that in some circumstances (e.g., when more relevant guidance that could be applied is not available), it may be appropriate for an entity to apply the principles in the new revenue standard to collaborations or partnerships.

How we see it

Under today's guidance, identifying the customer can be difficult, especially when multiple parties are involved in the transaction. This evaluation can require significant judgment, and the new guidance does not provide any additional considerations in this area.

Further, under the new guidance, transactions among partners in collaboration arrangements within the scope of the existing guidance on collaborations (ASC 808) are out of scope. However, ASC 808-10-45-3 states that when payments between parties in a collaboration are not within the scope of other authoritative accounting literature, the income statement classification should be based on an analogy to authoritative accounting literature or, if there is no appropriate analogy, a reasonable, rational and consistently applied accounting policy election. Therefore, this guidance allows an entity to apply the revenue recognition guidance by analogy to these types of arrangements, if that is the policy it has elected.

2.3 Interaction with other guidance

Entities entering into transactions that fall within the scope of multiple areas of accounting guidance currently have to separate those transactions into the elements that are accounted for under different pieces of literature. The new revenue guidance does not change this.

However, under today's guidance, revenue transactions often must be separated into elements that are accounted for under different pieces of revenue guidance (e.g., a multiple-element transaction that falls within the scope of both the multiple-element arrangements guidance in ASC 605-25 and the construction-type and production-type arrangements guidance in ASC 605-35[12]). Under the new guidance, this separation will not be required because there is a single revenue recognition model.

The new standard provides guidance for arrangements partially within the scope of the revenue standard and partially in the scope of other standards, as follows:

Excerpt from the Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Scope and Scope Exceptions

Transactions

606-10-15-4

A contract with a customer may be partially within the scope of this Topic and partially within the scope of other Topics listed in paragraph 606-10-15-2.

a. If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the **transaction price** the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics and shall apply paragraphs 606-10-32-28 through 32-41 to allocate the amount of the transaction price that remains (if any) to each **performance obligation** within the scope of this Topic and to any other parts of the contract identified by paragraph 606-10-15-4(b).

b. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply the guidance in this Topic to separate and/or initially measure the part (or parts) of the contract.

Only after applying any other applicable guidance will an entity apply the revenue guidance to the remaining elements of an arrangement. Some examples of where separation and/or allocation are addressed in other literature include the following:

- ASC 460, *Guarantees*, provides that a liability should be recognized, based on the guarantee's estimated fair value, when a guarantee is issued as part of a multiple-element arrangement. Therefore, for arrangements that include a guarantee and revenue elements, once the fair value of the guarantee has been determined, the remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement in accordance with the revenue recognition standard.
- ASC 840, *Leases*, provides guidance regarding the allocation of an arrangement's consideration between the lease and executory costs within a contractual arrangement. However, this guidance refers to the revenue guidance, specifically ASC 606-10-15-4 and

> paragraphs 606-10-32-38 through 32-41, for direction on allocating the total consideration between the deliverables subject to ASC 840 and those that are not within the scope of ASC 840. Accordingly, the estimated transaction price should be allocated between the deliverables within the scope of ASC 840 and any deliverables within the scope of the revenue guidance based on the relative selling price of each deliverable.

It is important to note that the FASB is considering changes to ASC 840. As a result, the manner in which the new revenue standard interacts with this piece of literature could also change in the future. However, we currently anticipate that the new revenue standard will be effective before or at the same time any new guidance on lease accounting will be effective.

If an element of the arrangement is covered by another ASC topic but that topic does not specify how to separate and/or initially measure that element, the entity will apply the revenue guidance for purposes of separation and/or measurement. For example, specific guidance does not exist on the separation and measurement of the different parts of an arrangement when an entity sells a business and also enters into a long-term supply agreement with the other party. Differences in current practice likely exist on the accounting for these often complex arrangements. It is unclear how these arrangements will be accounted for under the new revenue standard. See Section 6.6 for further discussion of the effect on the allocation of arrangement consideration when an arrangement includes both revenue and non-revenue elements.

The new standard also provides guidance on the accounting for certain costs such as the incremental costs of obtaining a contract and the costs of fulfilling a contract. However, the standard requires that the cost guidance be applied only if there is no other applicable guidance for these costs. See Section 8.3 for further discussion of the cost guidance in the new standard. In addition, the consequential amendments associated with the new revenue guidance include modifications for the recognition of a gain or loss on the transfer of a nonfinancial asset (e.g., assets within the scope of ASC 360, *Property, Plant and Equipment*, and intangible assets within the scope of ASC 350, *Intangibles — Goodwill and Other*).

3 Identify the contract with the customer

To apply the model, an entity must first identify the contract, or contracts, to provide goods and services to customers. Any contracts that create enforceable rights and obligations fall within the scope of the new guidance. Such contracts may be written, oral or implied by the entity's customary business practice. For example, an entity's past business practices may influence its determination of when an arrangement meets the definition of a contract with a customer. An entity that has an established practice of starting performance based on oral agreements with its customers may determine that such oral agreements meet the definition of a contract.

In the Basis for Conclusions, the Boards acknowledge that the determination of whether an arrangement has created enforceable rights is a question of law and that the factors that determine enforceability may differ by jurisdiction. The Boards also clarified that while the contract must be legally enforceable to be within the scope of the guidance, the performance obligations within the arrangement can be based on valid expectations of the customer, even if the promise is not enforceable.

As a result, an entity may have to account for an arrangement as soon as performance begins rather than delay revenue recognition until the arrangement is documented in a signed contract, as is often the case in current practice. However, certain arrangements may require a written contract to comply with jurisdictional law or trade regulation, and these requirements should be considered in determining whether a contract exists.

Illustration 3-1: Oral contract

IT Support Co. provides online technology support for consumers remotely via the internet. For a flat fee, IT Support Co. will scan a customer's personal computer (PC) for viruses, optimize the PC's performance and solve any connectivity problems. When a customer calls to obtain the scan services, IT Support Co. describes the services it can provide and states the price for those services. When the customer agrees to the terms stated by the representative, payment is made over the telephone. IT Support Co. then gives the customer the information needed to obtain the scan services (e.g., an access code for the website) and provides the services when the customer connects to the internet and logs on to the entity's website (which may be that day or a future date).

In this example, IT Support Co. and its customer are entering into an oral agreement, which is legally enforceable in this jurisdiction, for IT Support Co. to repair the customer's PC and for the customer to provide consideration by transmitting a valid credit card number and authorization over the telephone. The required criteria (discussed further in ASC 606-10-25-1 below) are all met, and this agreement would be within the scope of the new revenue model, even if the entity has not yet performed the scan services.

3.1 Attributes of a contract

To help entities determine whether (and when) their arrangements with customers are contracts within the scope of the new guidance, the Boards identified certain attributes that must be present. These criteria are assessed at the inception of the arrangement. If the criteria are met at that time, an entity does not reassess the criteria unless there is an indication of a significant change in facts and circumstances. For example, if the customer's ability to pay significantly deteriorates, an entity would have to reassess whether it is probable that the entity will collect the consideration for which it is entitled in exchange for transferring the remaining goods and services under the arrangement. The updated assessment is prospective in nature and would not change the conclusions associated with goods and services already transferred.

If the criteria are not met, the arrangement should not be considered a revenue contract, and the guidance discussed in Section 3.4 should be applied. However, entities should continue to assess the criteria throughout the terms of the arrangement to determine if they are subsequently met. Once met, the entity would then consider the arrangement to be a revenue contract with a customer. The model in the standard would then apply, rather than the guidance discussed in Section 3.4. The standard includes the criteria as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying the Contract

606-10-25-1

An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

b. The entity can identify each party's rights regarding the goods or services to be transferred.

c. The entity can identify the payment terms for the goods or services to be transferred.

d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

e. It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).

3.1.1 Parties have approved the contract and are committed to perform their respective obligations

As indicated in the Basis for Conclusions, the Boards included this criterion because a contract might not be legally enforceable without approval of both parties. Further, the Boards decided that the form of the contract (i.e., oral, written or implied) does not, in and of itself, determine whether the parties have approved and are committed to the contract. Instead, an entity must consider all relevant facts and circumstances when assessing whether the parties intend to be bound by the terms and conditions of the contract. As a result, in some cases, the parties to an oral or implied contract may have the intent and the commitment to fulfill their respective obligations while, in other cases, a written contract may be required to determine that the parties have approved the arrangement and are committed to perform.

Considering oral or implied agreements to be contracts may be a significant change in practice for some entities. SAB Topic 13, *Revenue Recognition,* provides four criteria for the recognition of revenue, including that "persuasive evidence of an arrangement exists."

Further, SAB Topic 13 refers to SOP 97-2 (codified in ASC 985-605), which provides guidance on determining whether persuasive evidence of an arrangement exists. Generally, today's guidance indicates that if an entity operates in a manner that does not rely on contracts to document formal agreement, some other evidence must exist to document the arrangement (e.g., purchase orders, online authorizations). In addition, that guidance states that if an entity has a customary business practice of using written contracts to document formal arrangements, evidence of any arrangement exists only by a fully executed contract.

In addition to approving the contract, the entity must also be able to conclude that both parties are committed to perform their respective obligations. That is, the entity must be committed to providing the promised goods and services, and the customer must be committed to purchasing those promised goods and services. In the Basis for Conclusions, the Boards clarified that an entity and a customer do not always have to be committed to fulfilling all of their respective rights and obligations for a contract to meet this requirement. For example, the Boards cited a supply agreement between two parties with stated minimums under which the customer doesn't always buy the required minimum amount and the entity doesn't always enforce its right to make the customer make those minimum purchases. Regardless, the Boards said that, in such a situation, it may still be possible for the entity to demonstrate there is sufficient evidence to conclude that the parties are substantially committed to the contract.

Termination clauses are an important consideration when determining whether both parties are committed to perform under a contract and, consequently, whether a contract exists. If each party has the unilateral right to terminate a "wholly unperformed" contract without compensating the counterparty, the standard states that, for purposes of this standard, a contract does not exist, and its accounting and disclosure requirements would not apply. However, if only one party has the right to terminate a contract, such a contract is within the scope of the new guidance, and the standard's accounting and disclosure requirements are applicable. Any arrangement in which the vendor has not provided any of the contracted goods or services and has not received or is not entitled to receive any of the contracted consideration is considered to be a "wholly unperformed" contract.

This criterion does not address collectibility. That topic is addressed in a separate criterion and is discussed more fully in Section 3.1.5.

3.1.2 Each party's rights can be identified

This criterion is relatively straightforward. If the goods and services to be provided in the arrangement cannot be identified, it is not possible to conclude that an entity has a contract within the scope of the arrangement. The Boards indicated that if the promised goods and services cannot be identified, the transfer of control of those goods and services also cannot be assessed.

3.1.3 Payment terms are identified

Identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. Provided there is an enforceable right to payment (i.e., enforceability as a matter of law) and the contract contains sufficient information to enable the entity to estimate the transaction price (see further discussion on estimating the transaction price in Section 5), the contract would qualify for accounting under the model (assuming the remaining criteria in ASC 606-10-25-1 have been met).

3.1.4 Commercial substance

The Boards included this criterion to prevent entities from artificially inflating revenue. A contract that does not have 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) should not

be accounted for under the standard. Historically, some entities in high-growth industries engaged in round-tripping transactions in which goods and services were transferred back and forth between the same entities in an attempt to show higher transaction volume and higher gross revenue. This is also a risk in arrangements involving nonmonetary consideration. Determining whether a contract has commercial substance for purposes of the revenue standard is consistent with the commercial substance determination elsewhere in US GAAP, such as in the nonmonetary transactions guidance in ASC 845.[10] This determination may require significant judgment. In all situations, the entity should be able to demonstrate a substantive business purpose for the nature and structure of its transactions.

In a change from existing guidance, the new standard does not contain prescriptive guidance specific to advertising barter transactions. We anticipate entities will need to carefully consider the "commercial substance" criterion when evaluating these types of transactions to ensure that they have commercial substance.

3.1.5 Collectibility

Under the revenue standard, collectibility refers to the customer's ability and intent to pay the amount of consideration to which the entity expects to be entitled. The Boards concluded that assessing a customer's credit risk is an important part of determining whether a contract, as defined by the standard, exists. That is, the Boards believe that it is a key part in determining the extent to which the customer has the ability and the intent to pay the expected consideration.

This criterion essentially acts like a collectibility threshold. The new standard requires an entity to evaluate at contract inception (and when significant facts and circumstances change) whether it is probable that it will collect the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer. This is similar to today's guidance, in which revenue recognition is permitted only when collectibility is reasonably assured (assuming other basic revenue recognition criteria have been met).

For purposes of this analysis, the term "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. Under IFRS, the standard uses the same term "probable," which means "more likely than not" — a lower threshold than "probable" under US GAAP. The customer's ability to pay a specified amount of consideration based on the amount to which the entity expects to be entitled and the customer's intention to pay the consideration when it becomes payable should be assessed for the noncancelable term of the contract. All facts and circumstances should be considered in the analysis. If it is not probable that the entity will collect amounts due, the contract should not be accounted for under the revenue model until the concerns about collectibility have been resolved (see Section 3.4 for further discussion).

It is important to note that the collectibility assessment relates to the amount of consideration to which an entity expects to be entitled (i.e., the transaction price), not the stated contract price. The transaction price may be less than the contract price because, for example, an entity intends to offer a price concession. Therefore, before determining if a contract with a customer exists, an entity will first need to estimate the transaction price so the appropriate values can be assessed for collectibility.

Although the overall notion of collectibility in the new standard is similar to the current collectibility requirement in SAB Topic 13, applying the concept to a portion of the contractual amount instead of the total contract price is a significant change. SAB Topic 13 requires that the entire contract price must be reasonably assured before an entity can recognize any revenue on the arrangement. This difference could result in the earlier recognition of revenue for an arrangement in which a portion of the contract price is considered to be at risk, but not the entire amount.

The standard provides the following example of when an implicit price concession exists, whereby the consideration amount is not the stated contract amount:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 2 — Consideration Is Not the Stated Price—Implicit Price Concession

606-10-55-99

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of $1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

606-10-55-100

When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraphs 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not $1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to $400,000.

606-10-55-101

The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect $400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of $400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the guidance in this Topic.

How we see it

Entities may struggle with applying the collectibility criterion. The Boards have indicated that if an entity believes it will receive partial payment for performance, that may be sufficient to determine the arrangement meets the definition of a contract (and that the expected shortfall of consideration is more akin to an implied price concession, see Section 5.1.1). However, significant judgment will be required to determine when a partial payment is a contract with an implied price concession or an impairment loss and when it is an arrangement lacking sufficient substance to be considered a contract within the scope of the guidance. Also, entities will need to evaluate and update their internal control over financial reporting for the process of identifying contracts, particularly for the collectibility criterion.

3.2 Combining contracts

In most cases, entities will apply the model to individual contracts with a customer. However, the new standard *requires* entities to combine contracts entered into at or near the same time with the same customer if they meet one or more of the criteria indicated below:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Combination of Contracts

606-10-25-9

An entity shall combine two or more **contracts** entered into at or near the same time with the same **customer** (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

a. The contracts are negotiated as a package with a single commercial objective.

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single **performance obligation** in accordance with paragraphs 606-10-25-14 through 25-22.

Some modifications are accounted for by allocating consideration to performance obligations that have been fully satisfied, but others are accounted for prospectively.

In the Basis for Conclusions, the Boards clarified that negotiating multiple contracts at the same time is not sufficient evidence to demonstrate that the contracts represent a single arrangement.

The requirement to combine contracts is generally consistent with the underlying principles in today's guidance. As a result, entities may reach similar conclusions about combining contracts as they do under today's guidance.

However, in some situations, entities may *elect* to combine multiple contracts for purposes of revenue recognition. For example, the new guidance states that an entity can account for a portfolio of similar contracts collectively if it expects that the result will not be materially different from the result of applying the guidance to the individual contracts. The Boards said that they did not intend for an entity to quantitatively evaluate every possible outcome when concluding that the portfolio approach is not materially different. Instead, they indicated that an entity should be able to take a reasonable approach to determine the portfolios that would be representative of its types of customers, and that an entity should use judgment in selecting the size and composition of these portfolios.

3.3 Contract modifications

Parties to an arrangement frequently agree to modify the scope or price (or both) of their contract. If that happens, an entity must determine whether the modification creates a new contract or whether it should be accounted for as part of the existing contract. Generally, it is clear when a contract modification has taken place, but in certain circumstances, that determination is more difficult. To assist entities with making this determination, the standard contains the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Contract Modifications

606-10-25-10

A contract modification is a change in the scope or price (or both) of a **contract** that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply the guidance in this Topic to the existing contract until the contract modification is approved.

606-10-25-11

A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the **transaction price** arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

The guidance above illustrates that the Boards intended it to apply more broadly than to only finalized modifications. That is, this guidance demonstrates that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both). Instead of focusing on the finalization of a modified agreement, the guidance focuses on the enforceability of the changes to the rights and obligations in the arrangement. Once the entity determines the revised rights and obligations are enforceable, the entity should account for the contract modification.

The standard provides the following example to illustrate this point:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 9 — Unapproved Change in Scope and Price

606-10-55-134

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to

compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

606-10-55-135

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

Once an entity has determined that a contract has been modified, the entity has to determine the appropriate accounting for the modification. Certain modifications are treated as separate, standalone contracts, while others are combined with the original contract and accounted for in that manner. The standard includes the following guidance for determining the appropriate accounting approach:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Contract Modifications

606-10-25-12

An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).

b. The price of the contract increases by an amount of consideration that reflects the entity's **standalone selling prices** of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

606-10-25-13

If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining

> **performance obligations** (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
>
> 1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as **revenue** and
> 2. The consideration promised as part of the contract modification.
>
> b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).
>
> c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

The requirement to determine whether to treat a change in contractual terms as a separate contract or a modification to an existing contract is relatively consistent with the current guidance for contract accounting in ASC 605-35.

It is important to note, however, when assessing how to account for the contract modification, an entity must consider how any revisions to promised goods or services interact with the rest of the arrangement. That is, although a contract modification may add a new good or service that would be distinct in a standalone transaction, the new performance obligation may not be distinct when it is part of a contract modification. For example, in a building renovation project, a customer may request a contract modification to add a new room. The construction firm may commonly sell the construction of a room addition on a standalone basis, which would indicate that the service is distinct. However, when that service is added to an existing arrangement and the entity has already determined that the entire project is a single performance obligation, the added goods and services normally would be combined with the existing bundle of goods and services.

3.3.1 Contract modification represents a separate contract

Certain contract modifications are treated as separate, new contracts. For these modifications, the accounting for the original contract is not affected by the modification, and the revenue recognized to date on the original contract is not adjusted. Further, any performance obligations remaining under the original contract continue to be accounted for under the original contract.

Two criteria must be met for a modification to be treated as a separate contract. The first is that the additional goods and services included in the modification must be distinct from the goods and services in the original arrangement. This assessment should be done in accordance with the standard's general requirements for determining whether promised goods and services are distinct (see Section 4.2). Only modifications that add distinct goods and services to the arrangement can be treated as separate contracts. Arrangements that reduce the

amount of promised goods or services or change the scope of the original promised goods and services, by their very nature, cannot be considered separate contracts and have to be considered modifications of the original contracts (see Section 3.3.2).

The second criterion is that the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. In determining the standalone selling price, however, entities have some flexibility to adjust the selling price, depending on the facts and circumstances. For example, a vendor may give a current customer a discount on additional goods because the vendor would not incur selling-related costs that it typically incurs for new customers. In this example, the entity may determine that the incremental transaction consideration meets this criterion, even though the discounted price is less than the standalone selling price of that good or service for a new customer. In another example, an entity may conclude that, with the additional purchases, the customer qualifies for a volume-based discount.

See Example 5, Case A, below for an illustration of a contract modification that represents a separate contract.

3.3.2 Contract modification is not a separate contract

Contract modifications that do not meet the criteria discussed in Section 3.3.1 are considered changes to the original contract and are not treated as separate contracts. This includes contract modifications that modify or remove previously agreed-upon goods and services. An entity would account for the effects of these modifications differently, depending on which one of the three scenarios described in ASC 606-10-25-13 most closely aligns with the facts and circumstances of the modification.

- If the remaining goods and services 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. For these modifications, the revenue recognized to date on the original contract (i.e., the amount associated with the completed performance obligations) is not adjusted. Instead, the remaining portion of the original contract and the modification are accounted for together on a prospective basis by allocating the remaining consideration to the remaining performance obligations. See Example 5, Case B, below for an illustration of this scenario.

- If the remaining goods and services to be provided after the contract modification are not distinct from those 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. For these modifications, the entity will adjust revenue previously recognized, either up or down, to reflect the effect that the contract modification has on the transaction price and the measure of progress (i.e., the revenue adjustment is made on a cumulative catch-up basis). See Example 8 below for an illustration of this type of modification.

- Finally, a change in a contract also may be treated as a combination of the two: a modification of the existing contract and the creation of a new contract. In this case, an entity would not adjust the accounting for completed performance obligations that are distinct from the modified goods or services. However, the entity would adjust revenue previously recognized, either up or down, to reflect the effect of the contract modification on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and the measure of progress.

The standard includes the following examples to illustrate some of these concepts:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 5 — Modification of a Contract for Goods

606-10-55-111

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

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

606-10-55-112

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.

606-10-55-113

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

606-10-55-114

During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of $80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of $15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of $900 ($15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is $1,500 or $50 per product. That price comprises the agreed-upon price for the additional 30 products of $2,400, or $80 per product, less the credit of $900.

606-10-55-115

At the time of modification, the entity recognizes the $900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of $80 per product does not reflect the standalone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 606-10-25-12 to be accounted for as a separate contract. Because

the remaining products to be delivered are distinct from those already transferred, the entity applies the guidance in paragraph 606-10-25-13(a) and accounts for the modification as a termination of the original contract and the creation of a new contract.

606-10-55-116

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}.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 8 — Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue

606-10-55-129

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of $1 million and a bonus of $200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 606-10-25-27(b) because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

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

606-10-55-130

At contract inception, the entity excludes the $200,000 bonus from the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

606-10-55-131

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

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

606-10-55-132

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by $150,000 and $120,000, respectively. Total potential consideration after the modification is $1,350,000 ($1,150,000 fixed consideration + $200,000 completion bonus). In addition, the allowable time for achieving the $200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized in accordance with paragraph 606-10-32-11 and includes the $200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 606-10-25-19(b) and concludes (on the basis of the factors in paragraph 606-10-25-21) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

606-10-55-133

Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 606-10-25-13(b)). The entity updates its measure of progress and estimates that it has satisfied 51.2 percent of its performance obligation ($420,000 actual costs incurred ÷ $820,000 total expected costs). The entity recognizes additional revenue of $91,200 [(51.2 percent complete × $1,350,000 modified transaction price) — $600,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

How we see it

Entities will need to carefully evaluate performance obligations at the date of a modification to determine whether the remaining goods or services to be transferred are distinct. This assessment is important because the accounting can vary significantly depending on the conclusions reached.

3.4 Arrangements that do not meet the definition of a contract under the standard

An arrangement that does not meet the criteria of a contract under the standard must be accounted for as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying the Contract

606-10-25-7

When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as **revenue** only when either of the following events has occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

606-10-25-8

An entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 606-10-25-7 occurs or until the criteria in 606-10-25-1 are subsequently met (see paragraph 606-10-25-6). Depending on the facts and circumstances relating to the contract, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

As noted in the Basis for Conclusions, the Boards decided to include the above guidance to prevent entities from seeking alternative guidance or improperly analogizing to the new revenue recognition guidance in circumstances in which an executed contract does not meet the criteria in paragraph 606-10-25-1 (as discussed in Section 3.1). Consequently, the Boards specified that in cases in which the contract does not the meet the criteria, an entity should recognize nonrefundable consideration received as revenue only when one of the events above has occurred (i.e., full performance and substantially all consideration received or the contract has been terminated) or the contract subsequently meets the criteria in 606-10-25-1. Until that happens, any consideration received from the customer is initially accounted for as a liability (not revenue), and the liability is measured at the amount of consideration received from the customer. The existing guidance in US GAAP should be applied to assets related to contracts that do not meet the criteria in paragraph 606-10-25-1 (e.g., ASC 330[13] for inventory).

In the Basis for Conclusions, the Boards indicated they intended this accounting to be similar to the "deposit method" that was previously included in US GAAP and applied when there was no consummation of a sale. The standard includes the following example to illustrate this concept:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 1 — Collectibility of the Consideration

606-10-55-95

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.

606-10-55-96

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. The entity's cost of the building is $600,000. The customer obtains control of the building at contract inception.

606-10-55-97

In assessing whether the contract meets the criteria in paragraph 606-10-25-1, 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 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.

606-10-55-98

Because the criteria in paragraph 606-10-25-1 are not met, the entity applies paragraphs 606-10-25-7 through 25-8 to determine the accounting for the nonrefundable deposit of $50,000. The entity observes that none of the events described in paragraph 606-10-25-7 have occurred — that is, the entity has not received substantially all of the consideration and it has not terminated the contract. Consequently, in accordance with paragraph 606-10-25-8, the entity accounts for the nonrefundable $50,000 payment as a deposit liability. The entity continues to account for the initial deposit, as well as any future payments of principal and interest, as a deposit liability and does not derecognize the real estate asset. Also, the entity does not recognize a receivable until such time that the entity concludes that the criteria in paragraph 606-10-25-1 are met (that is, the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 606-10-25-7 has occurred. 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.

4 Identify the performance obligations in the contract

To apply the new guidance, an entity must identify the promised goods and services within the contract and determine which of those goods and services are separate, or distinct, performance obligations (i.e., the unit of account for purposes of applying the standard). Each of these concepts is discussed below.

4.1 Identifying the promised goods and services in a contract

The new standard provides the following guidance with respect to identifying the performance obligations in a contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Identifying Performance Obligations

606-10-25-14

At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

606-10-25-15

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.

b. In accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Promises in Contracts with Customers

606-10-25-16

A **contract** with a **customer** generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the **performance obligations** identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

606-10-25-17

Performance obligations do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

Distinct Goods or Services

606-10-25-18

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 55-65)

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).

The new standard requires an entity to identify, at contract inception, all promised goods and services and determine which of these promised goods or services (or bundle of goods and services) represent separate performance obligations. Unlike today's guidance, which doesn't define the term "deliverable," the new standard provides guidance on the types of items that may be goods or services promised in the contract. In addition, the standard indicates that certain activities are not promised goods or services, such as activities that an entity must perform to satisfy its obligation to deliver the promised goods and services (e.g., internal administrative activities).

The Boards noted that in many cases all of the promised goods or services in a contract might be identified explicitly in that contract. However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices. The standard indicates that when an entity identifies the promises in a contract, it should consider whether the customer has a valid expectation that the entity will provide a good or service. That is, the notion of a performance obligation also includes constructive performance obligations based on factors outside of a written contract (e.g., past business practice, industry norms). The Boards also noted that implied promises in a contract do not need to be enforceable by law. If the customer has a valid expectation, the customer would view those promises as part of the negotiated exchange. The Boards provided examples of such promised goods or services in its

Basis for Conclusions, including "free" handsets provided by telecommunication entities; "free" maintenance provided by automotive manufacturers; and customer loyalty points awarded by supermarkets, airlines and hotels. Although the entity might consider those goods or services to be marketing incentives or incidental goods or services, the Boards concluded they are goods or services for which the customer pays and to which the entity should allocate consideration (i.e., identify as performance obligations) for purposes of revenue recognition.

As noted in the Basis for Conclusions, the Boards also decided that a performance obligation may exist for a promise to provide a good or service in the future. Depending on the contract, a right to goods or services to be provided in the future that the customer can resell or provide to its customer may represent promises to the customer if those rights existed at the time that the parties agreed to the contract. These types of promises exist in distribution networks in various industries and are common in the automotive industry.

How we see it

The inclusion of guidance on what types of items may be goods and services in a contract (rather than administrative activities that an entity undertakes to provide the promised goods and services) is a change from today's guidance. While some might not agree with some of the Boards' conclusions, the guidance should be helpful when applying the standard.

The new standard includes the following example to illustrate how to apply the guidance on identifying performance obligations in various scenarios:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 12 — Explicit and Implicit Promises in a Contract

606-10-55-151

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

Case A — Explicit Promise of Service

606-10-55-152

In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (that is, "free") to any party (that is, the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.

606-10-55-153

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 determines that the promise to provide maintenance services is a performance obligation (see paragraph 606-10-25-18(g)). The entity concludes that the promise would represent a performance obligation regardless of whether the entity, the distributor, or a third party provides the service. Consequently, the entity allocates a portion of the transaction price to the promise to provide maintenance services.

Case B — Implicit Promise of Service

606-10-55-154

The entity has historically provided maintenance services for no additional consideration (that is, "free") to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor, and the final contract between the entity and the distributor does not specify terms or conditions for those services.

606-10-55-155

However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (that is, the distributor and end customers) in accordance with paragraph 606-10-25-16. Consequently, the entity identifies the promise of maintenance services as a performance obligation to which it allocates a portion of the transaction price.

Case C — Services Are Not a Performance Obligation

606-10-55-156

In the contract with the distributor, the entity does not promise to provide any maintenance services. In addition, the entity typically does not provide maintenance services, and, therefore, the entity's customary business practices, published policies, and specific statements at the time of entering into the contract have not created an implicit promise to provide goods or services to its customers. The entity transfers control of the product to the distributor and, therefore, the contract is completed. However, before the sale to the end customer, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.

606-10-55-157

The promise of maintenance is not included in the contract between the entity and the distributor at contract inception. That is, in accordance with paragraph 606-10-25-16, the entity does not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers. Consequently, the entity does not identify the promise to provide maintenance services as a performance obligation. Instead, the obligation to provide maintenance services is accounted for in accordance with Topic 450 on contingencies.

4.2 Separate performance obligations

After identifying the promised goods and services within a contract, an entity determines which of those goods and services will be accounted for as separate performance obligations. That is, the entity decides what will be the individual units of account. Promised goods and services represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods and services) or if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer (see Section 4.2.2).

4.2.1 Determination of distinct

The new standard outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct: (1) consideration at the level of the individual good or service (i.e., the goods or services are capable of being distinct) and (2) consideration of whether the good or service is separable from other promises in the

contract (i.e., the good or service is distinct within the context of the contract). Both of these criteria must be met to conclude that the good or service is distinct, as discussed further below. If these criteria are met, the individual units of accounting must be separated.

The model provides the following guidance to determine whether a good or service is distinct:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Distinct Goods or Services

606-10-25-19

A good or service that is promised to a customer is distinct if both of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

Capable of being distinct

The new standard states that a customer can benefit from a good or service if the good or service could be used, consumed, sold for an amount greater than scrap value or otherwise held in a way that generates economic benefits. A customer may be able to benefit from some goods or services on their own or in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. The fact that an entity regularly sells a good or service separately indicates that a customer can benefit from that good or service on its own or with readily available resources.

As noted in the Basis for Conclusions, the assessment of whether the "customer can benefit from the goods or services on its own" should be based on the characteristics of the goods or services themselves instead of how the customer might use the goods or services. As a result, an entity disregards any contractual limitations that may prevent the customer from obtaining those readily available resources from a party other than the entity when making this assessment.

Distinct within the context of the contract

Once an entity determines whether a good or service is distinct based on its individual characteristics, the entity considers whether the good or service is separable from other promises in the contract. The standard provides the following guidance to make this determination:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Distinct Goods or Services

606-10-25-21

Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable (in accordance with paragraph 606-10-25-19(b)) include, but are not limited to, the following:

a. The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.

b. The good or service does not significantly modify or customize another good or service promised in the contract.

c. The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

The Boards note in the Basis for Conclusions that, typically, a good or service is not separable from other promises in the contract when an entity uses the good or service as an input into a single process or project that is the output of the contract. For example, in construction contracts, an entity may provide an integration service in addition to providing goods or services to complete the construction tasks. Although the indicator in ASC 606-10-25-21(a) was developed in response to feedback received from the construction industry, the indicator applies to all industries.

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. This approach differs slightly from today's guidance, which generally requires an entity to combine that element with the last item to be delivered. An entity may account for all the goods or services promised in a contract as a single performance obligation if the entire bundle of promised goods and services is the only distinct performance obligation identified.

The example below illustrates how an entity applies the two-step process for determining whether promised goods and services in an arrangement are distinct:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 11 — Determining Whether Goods or Services Are Distinct

Case A — Distinct Goods or Services

606-10-55-141

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, an 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.

606-10-55-142

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. 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.

606-10-55-143

The entity also considers 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 particular, the entity observes that the installation service does not significantly modify or customize the software itself, and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

606-10-55-144

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

a. The software license

b. An installation service

c. Software updates

d. Technical support.

606-10-55-145

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software license in accordance with paragraph 606-10-55-60 (see Example 54 in paragraphs 606-10-55-362 through 55-363).

Case B — Significant Customization

606-10-55-146

The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

606-10-55-147

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity 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)). In addition, the software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Although the customized installation service can be provided by other entities, the entity determines that within the context of the contract, 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) (on the basis of the factors in paragraph 606-10-25-21) is not met. Thus, the software license and the customized installation service are not distinct.

606-10-55-148

As in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

606-10-55-149

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Customized installation service (that includes the software license)

b. Software updates

c. Technical support.

606-10-55-150

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

It is important to note that the assessment of whether a good or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular good or service is distinct (or not distinct) in all instances. The manner in which promised goods and services are bundled in a contract can affect the conclusion of whether a good or service is distinct. We anticipate that entities may end up treating the same goods and services differently, depending on how those goods and services are bundled in a contract.

4.2.2 *Series of distinct goods and services that are substantially the same and that have the same pattern of transfer*

During deliberations, respondents raised questions about how certain types of promised goods or services that are transferred consecutively to a customer would be treated under the standard. Examples of such arrangements include a long-term service contract or the promise of a number of identical goods. For example, some thought it wasn't clear in the Exposure Draft whether a three-year service contract should be accounted for as a single performance obligation or a number of performance obligations covering smaller time periods (e.g., yearly, quarterly, monthly, daily). To address this question, the Boards clarified that even if a good or service is determined to be distinct, if that good or service is part of a series of goods and services that are substantially the same and that have the same pattern of transfer, that series of goods or services must be treated as a single performance obligation if both of the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer consecutively represents a performance obligation that would be satisfied over time in accordance with ASC 606-10-25-27 (see Section 7.1) if it were accounted for separately.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series. See Section 7.1.4 for a discussion on measuring progress.

It should be noted that in long-term service agreements when the consideration is fixed, the accounting generally will not change (assuming there is not a significant financing component), regardless of whether a single performance obligation or multiple performance obligations are identified. However, in arrangements involving variable consideration, this requirement could have a significant effect. See Section 6.3 for further discussion on allocating variable consideration.

As noted in the Basis for Conclusions, the Boards observed that this guidance applies to goods or services that are delivered consecutively, rather than concurrently. The Boards determined the guidance need not specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. That is, the Boards believed that in those cases, an entity would not be precluded from accounting for the goods or services as if they were a single performance obligation if the outcome would be the same as treating the goods and services as individual performance obligations.

How we see it

The first step of the two-step approach to determine whether goods or services are distinct is similar to the principles for determining separate units of accounting under today's guidance in ASC 605-25. However, the second step of looking at the goods or services within the context of the contract is a new requirement. Therefore, entities may reach different conclusions about separate performance obligations under the new model than they do when identifying the units of accounting today.

Entities that currently apply other guidance, such as the software revenue recognition guidance in ASC 985-605 or the construction contract accounting guidance in ASC 605-35, may also reach different conclusions from those reached today.

4.3 Goods and services that are not distinct

If a good or service does not meet the criteria to be considered distinct, an entity is required to combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. The combination of multiple goods or services could result in the entity accounting for all of the goods or services promised in the contract as a single performance obligation. This could also result in an entity combining a good or service that is not considered distinct with another good or service that, on its own, would have met the criteria to be considered distinct (see Section 4.2).

Illustration 4-1: Bundling inseparable goods and services

Entity Z is a software development firm that provides hosting services to a variety of consumer products companies. Entity Z offers a hosted inventory management software product that requires the customer to purchase hardware from Entity Z. In addition, customers may purchase professional services from Entity Z to migrate historical data and create interfaces with existing back-office accounting systems. Entity Z always delivers the hardware first, followed by professional services and finally the ongoing hosting services.

Scenario A — All goods and services sold separately

Entity Z determines that all of the individual goods and services in the contract are distinct because the entity regularly sells each component of the contract separately. Entity Z also determines that the goods and services are separable from other promises in the contract because it is not providing a significant service of integrating the goods and services and the level of customization is not significant. Further, because the customer could purchase or not purchase each good and service without significantly affecting the other goods and services purchased, the goods and services are not highly dependent on or highly interrelated with each other. Accordingly, the hardware, professional services and hosting services are each accounted for as separate performance obligations.

Scenario B — Hardware not sold separately

Entity Z determines that the professional services are distinct because it frequently sells those services on a standalone basis (e.g., Entity Z also performs professional services related to hardware and software it doesn't sell). Further, the entity determines that the hosting services are also distinct because it also sells those services on a standalone basis. For example, customers that have completed their initial contractual term and elect each month to continue purchasing the hosting services are purchasing those services on a standalone basis. The hardware, however, is always sold in a package with the professional and hosting services and the customer cannot use the hardware on its own or with resources that are readily available to it. As a result, Entity Z determines the hardware is not distinct.

Entity Z must determine which promised goods and services in the contract to bundle with the hardware. Entity Z likely would conclude that because the hardware is integral to the delivery of the hosted software, the hardware and hosting services should be accounted for as one performance obligation while the professional services, which are distinct, would be a separate performance obligation.

4.4 Principal versus agent considerations

Some contracts result in an entity's customer receiving goods or services from another entity that is not a direct party to the contract with the customer. The standard states that when other parties are involved in providing goods or services to an entity's customer, the entity must determine whether its performance obligation is to provide the good or service itself (i.e., the entity is a principal) or to arrange for another party to provide the good or service (i.e., the entity is an agent). The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognizes. That is, when the entity is the principal in the arrangement, the revenue recognized is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognized is the net amount to which the entity is entitled to retain in return for its services as the agent. The entity's fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

A principal's performance obligations in an arrangement differ from an agent's performance obligations. For example, if an entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity's performance obligation may be to provide the goods or services itself. Hence, the entity likely is acting as a principal and should recognize revenue in the gross amount to which it is entitled. An entity that obtains legal title of a product only momentarily before legal title is transferred to the customer is not necessarily acting as a principal. In contrast, if an agent facilitates the sale of goods or services to the customer in exchange for a fee or commission and generally does not control the goods or services for any length of time, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer.

Because the identification of the principal in a contract is not always clear, the Boards provided indicators that a performance obligation involves an agency relationship as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Principal versus Agent Considerations

606-10-55-39

Indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer) include the following:

a. Another party is primarily responsible for fulfilling the contract.

b. The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return.

c. The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.

d. The entity's consideration is in the form of a commission.

e. The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

As noted in the Basis for Conclusions, the above indicators are based on indicators that are included in today's revenue recognition guidance in US GAAP and IFRS. However, the indicators in ASC 606 have a different purpose than today's revenue recognition guidance in that they are based on the concepts of identifying performance obligations and the transfer of goods or services. Appropriately identifying the entity's performance obligation in a contract is fundamental to the determination of whether the entity is acting as an agent or a principal. That is, in order for the entity to conclude it is acting as the principal in the arrangement, the entity must determine that it controls the goods or services promised to the customer before those goods and services are transferred to the customer. The above indicators are meant to assist the entity in making that determination.

After an entity identifies its promise(s) and determines whether it is the principal or the agent, the entity recognizes revenue when it satisfies that performance obligation (as discussed in Section 7). In some contracts in which the entity is the agent, control of the goods or services promised by the agent might transfer before the customer receives the goods or services from the principal. For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

- The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.
- The points entitle the customers to future discounted purchases with another party (i.e., the points represent a material right to a future discount).
- The entity determines that it is an agent (i.e., its promise is 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.

In contrast, if the points entitle the customers to future goods or services to be provided by the entity, the entity may conclude it is not an agent. This is because the entity's promise is to provide those future goods or services, and thus, the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation may only be satisfied when the future goods or services are provided.

In other cases, the points may entitle customers to choose between future goods or services provided by either the entity or another party. In this situation, the nature of the entity's performance obligation may not be known until the customer makes its choice. That is, until the customer has chosen the goods or services to be provided (and thus whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Thus, the entity may not satisfy its performance obligation until it either delivers the goods or services or is no longer obliged to stand ready. If the customer subsequently chooses the goods or services from another party, the entity would need to consider whether it was acting as an agent and thus should recognize revenue for only a fee or commission that the entity received for providing the services to the customer and the third party. The Boards noted that this is consistent with previous revenue recognition guidance in IFRS for customer loyalty programs.

Although an entity may be able to transfer its obligation to provide goods or services to another party, the Boards have indicated that such a transfer may not always satisfy the performance obligation. Instead, the entity evaluates whether it has created a new performance obligation to obtain a customer for the entity that assumed the obligation (i.e., whether the entity is now acting as an agent).

How we see it

Consistent with current practice, entities will need to carefully evaluate whether a gross or net presentation is appropriate. Although the new standard includes guidance that is similar to existing guidance, there are some notable differences that may affect an entity's principal-agent judgments and conclusions. For example, the standard includes the notion of considering whether an entity has control of the goods and services as part of the evaluation, which adds an overarching principle for entities to evaluate in addition to the indicators. In addition, the new standard removes the requirement in today's guidance to weight certain indicators in the principal-agent determination more heavily than others. Consequently, this change gives entities the opportunity to assess the indicators for importance based on the facts and circumstances. Further, the elimination of the illustrative examples in today's guidance may affect an entity's principal-agent determination because judgments about similar circumstances may differ in the absence of specific guidance to influence the conclusions. However, it is too early to know how the new guidance will be applied in practice.

The standard includes the following examples to illustrate the application of the principal versus agent guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 47 — Promise to Provide Goods or Services (Entity is a Principal)

606-10-55-325

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance.

606-10-55-326

The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased; therefore, there is no credit risk.

606-10-55-327

The entity also assists the customers in resolving complaints with the service provided by airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

606-10-55-328

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for another party to provide those goods or services (that is, the entity is an agent), the entity considers the nature of its promise. The entity determines that its promise is to provide the customer with a ticket, which provides the right to fly on the specified flight or another flight if the specified flight is changed or cancelled. In determining whether the entity obtains control of the right to fly before control transfers to the customer and whether the entity is a principal, the entity considers the indicators in paragraph 606-10-55-39 as follows:

a. The entity is primarily responsible for fulfilling the contract, which is providing the right to fly. However, the entity is not responsible for providing the flight itself, which will be provided by the airline.

b. The entity has inventory risk for the tickets because they are purchased before they are sold to the entity's customers and the entity is exposed to any loss as a result of not being able to sell the tickets for more than the entity's cost.

c. The entity has discretion in setting the sales prices for tickets to its customers.

d. As a result of the entity's ability to set the sales prices, the amount that the entity earns is not in the form of a commission but, instead, depends on the sales price it sets and the costs of the tickets that were negotiated with the airline.

606-10-55-329

The entity concludes that its promise is to provide a ticket (that is, a right to fly) to the customer. On the basis of the indicators in paragraph 606-10-55-39, the entity concludes that it controls the ticket before it is transferred to the customer. Thus, the entity concludes that it is a principal in the transaction and recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 48 — Arranging for the Provision of Goods or Services (Entity is an Agent)

606-10-55-330

An entity sells vouchers that entitle customers to future meals at specified restaurants. These vouchers are sold by the entity, 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 vouchers in advance; 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.

606-10-55-331

The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers. The entity is entitled to 30 percent of the voucher price when it sells the voucher. The entity has no credit risk because the customers pay for the vouchers when purchased.

606-10-55-332

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.

606-10-55-333

To determine whether the entity is a principal or an agent, the entity considers the nature of its promise and whether it takes control of the voucher (that is, a right) before control transfers to the customer. In making this determination, the entity considers the indicators in paragraph 606-10-55-39 as follows:

a. The entity is not responsible for providing the meals itself, which will be provided by the restaurants.

b. The entity does not have inventory risk for the vouchers because they are not purchased before being sold to customers and the vouchers are nonrefundable.

c. The entity has some discretion in setting the sales prices for vouchers to customers, but the sales prices are jointly determined with the restaurants.

d. The entity's consideration is in the form of a commission, because it is entitled to a stipulated percentage (30 percent) of the voucher price.

606-10-55-334

The entity concludes that its promise is to arrange for goods or services to be provided to customers (the purchasers of the vouchers) in exchange for a commission. On the basis of the indicators in paragraph 606-10-55-39, the entity concludes that it does not control the vouchers that provide a right to meals before they are transferred to the customers. Thus, the entity concludes that it is an agent in the arrangement and recognizes revenue in the net amount of consideration to which the entity will be entitled in exchange for the service, which is the 30 percent commission it is entitled to upon the sale of each voucher.

4.5 Consignment arrangements

Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor, dealer). By shipping on a consignment basis, consignors are able to better market products by moving them closer to the end user; however, they do so without selling the goods to the intermediary (consignee).

The Boards provided the following indicators that an arrangement is a consignment arrangement:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Consignment Arrangements

606-10-55-80

Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

a. The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.

b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).

c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Entities entering into a consignment arrangement must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the inventory to the consignee or to transfer the inventory to the end customer). This determination should be based on whether control of the inventory has passed to the consignee upon delivery. Typically, a consignor will not relinquish control of consignment inventory until the inventory is sold to the end consumer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the inventory other than to pay the consignor the agreed-upon portion of the sale price once the consignee sells the product to a third party. As a result, revenue generally would not be recognized for consignment arrangements when the goods are delivered to the consignee because control has not transferred (i.e., the performance obligation to deliver goods to the customer has not yet been satisfied).

4.6 Customer options for additional goods or services

Many sales contracts give customers the option to purchase additional goods or services. These additional goods and services may be priced at a discount or may even be free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives, customer award credits (e.g., frequent flyer programs), contract renewal options (e.g., waiver of certain fees, reduced future rates) or other discounts on future goods or services.

The standard states that when an entity grants a customer the option to acquire additional goods or services, that option only is a separate performance obligation if it provides a material right to the customer. The right is material if it results in a discount 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). The Boards did not provide any bright lines about what constitutes a "material" right; however, they indicated in the Basis for Conclusions that the purpose of this guidance is to identify and account for options that customers are essentially paying for (often implicitly) as part of the transaction. If the discounted price in the option reflects the standalone selling price (separate from any existing relationship or contract), the entity is deemed to have made a marketing offer rather than having granted a material right. The standard states that this is the case even if the option can be exercised only because the customer entered into the earlier transaction. The assessment of whether the entity has granted its customer a material right could require significant judgment in some situations.

How we see it

The new standard establishes guidance for accounting for options in all transactions. Today's guidance for software revenue recognition (ASC 985-605) addresses some of the difficulties in distinguishing between an option and a marketing offer, but that guidance is not required for transactions that don't involve software (although it sometimes is applied by analogy). The new guidance on determining whether an option represents an additional promised good or service in an arrangement is similar to current guidance in ASC 985-605, but the new guidance requires a larger amount of arrangement consideration to be allocated to the option. This will delay revenue recognition. See Section 6.1.5 for further discussion on the measurement of options that are separate performance obligations.

The standard includes the following example to illustrate the determination of whether an option represents a material right:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 49—Option That Provides the Customer with a Material Right (Discount Voucher)

606-10-55-336

An entity enters into a contract for the sale of Product A for $100. As part of the contract, the entity gives the customer a 40 percent discount voucher for any future purchases up to $100 in the next 30 days. The entity intends to offer a 10 percent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 percent discount cannot be used in addition to the 40 percent discount voucher.

606-10-55-337

Because all customers will receive a 10 percent discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10 percent (that is, the additional 30 percent discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

606-10-55-338

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

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	

606-10-55-339

The entity allocates $89 to Product A and recognizes revenue for Product A when control transfers. The entity allocates $11 to the discount voucher and recognizes revenue for the voucher when the customer redeems it for goods or services or when it expires.

4.7 Sale of products with a right of return

An entity may provide its customers with a right to return a transferred product. A right of return may be contractual, an implicit right that exists due to the entity's customary business practice or a combination of both (e.g., an entity has a stated return period but generally accepts returns over a longer period). A customer exercising its right to return a product may receive a full or partial refund, a credit applied to amounts owed, a different product in exchange or any combination of these items.

Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept a returned product. The Boards decided that such an obligation does not represent a separate performance obligation. Instead, the Boards concluded that an entity makes an uncertain number of sales when it provides goods with a return right. That is, until the right of return expires, the entity is not certain how many sales will fail. Therefore, the Boards concluded that an entity should not recognize revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods. Instead, the potential for customer returns should be considered when an entity estimates the transaction price because potential returns are a component of variable consideration. This concept is discussed further in Section 5.2.2.

The Boards determined that exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one color or size for another) are not considered returns for the purposes of applying the new standard. Generally this would be a nonmonetary transaction within the scope of ASC 845. Further, contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties included in ASC 606. See further discussion on warranties in Section 8.1.

5 Determine the transaction price

The standard provides the following guidance with respect to determining the transaction price:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Determining the Transaction Price

606-10-32-2

An entity shall consider the terms of the contract **and its customary business practices to determine the** transaction price**. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a** customer**, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.**

606-10-32-3

The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

a. Variable consideration (see paragraphs 606-10-32-5 through 32-10 and 606-10-32-14)

b. Constraining estimates of variable consideration (see paragraphs 606-10-32-11 through 32-13)

c. The existence of a significant financing component in the contract (see paragraphs 606-10-32-15 through 32-20)

d. Noncash consideration (see paragraphs 606-10-32-21 through 32-24)

e. Consideration payable to a customer (see paragraphs 606-10-32-25 through 32-27).

606-10-32-4

For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

The transaction price is based on the amount to which the entity expects to be "entitled." This amount is meant to reflect the amount that the entity has rights to under the present contract. That is, the transaction price does not include estimates of consideration from future change orders for additional goods and services. The amount to which the entity is entitled also excludes amounts collected on behalf of another party, such as sales taxes. Note that entities can elect to include or exclude sales tax collected on behalf of third parties under today's guidance, but this policy election is not available under the new standard.

In many cases, the transaction price is readily determinable because the entity receives payment when it transfers promised goods or services and the price is fixed (e.g., the sale of goods in a retail store). In other situations, determining the transaction price is more challenging when it is variable, when payment is received at a different time from when the entity provides goods or services, or when payment is in a form other than cash. Consideration paid or payable by the vendor to the customer also may affect the determination of the transaction price.

Determining the transaction price is an important step in the model because this amount is allocated to the identified performance obligations and is recognized as revenue as those performance obligations are satisfied.

5.1 Variable consideration

The transaction price reflects an entity's expectations about the consideration it will be entitled to receive from the customer. The model provides the following guidance to determine whether consideration is variable and, if so, how it should be treated under the model:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Variable Consideration

606-10-32-5

If the consideration promised in a **contract** includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a **customer**.

606-10-32-6

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

606-10-32-7

The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

606-10-32-8

An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value — The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount — The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

> *606-10-32-9*
>
> An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

These concepts are discussed in more detail below.

5.1.1 Forms of variable consideration

As indicated in ASC 606-10-32-6, "variable consideration" is defined broadly and can take on many forms. It is important for entities to appropriately identify the different types of variable consideration included in a contract because the second step of estimating variable consideration requires entities to apply a constraint (as discussed further in Section 5.1.3) to each type of variable consideration.

Many types of variable consideration identified in the new standard are also considered variable under today's guidance. For example, if a portion of the transaction price depends on an entity meeting specified performance conditions and there is uncertainty about the outcome, this portion of the transaction price would be considered variable consideration under both today's guidance and the new standard.

However, certain amounts may be considered variable consideration under the new standard that are considered "fixed" today. For example, the new standard's definition of variable consideration includes amounts resulting from variability due to customer refunds or returns. As a result, a contract to provide a customer with 100 widgets at a fixed price per widget would be considered to include a variable component if the customer has the ability to return the widgets (see Section 5.2.2).

For some arrangements, the stated pricing has easily identifiable variable components. However, for other arrangements, the consideration may be variable because the facts and circumstances indicate that the entity may accept a lower price than the amount stated in the contract. This could be a result of the customer having a valid expectation that the entity will reduce its price because of the entity's customary business practices, published policies or specific statements made by the entity. This potential price reduction also could result from facts and circumstances indicating that the entity intends to offer a price concession to the customer.

The new standard suggests that if an entity is aware of potential collectibility issues at the onset of the contract but is still willing to enter into the contract, the arrangement may include implied price concessions. These implied price concessions are considered variable consideration under the new definition. However, as discussed in Section 3.1.5, an entity in this situation also has to determine whether it has entered into a valid arrangement with a customer. If an entity determined that it is not probable that it will collect the estimated transaction price from the customer (note that the estimated transaction price may be lower than the stated contract price), it cannot conclude that the contract is valid, and therefore, cannot consider the contract a revenue arrangement with a customer (see Section 3.4). That is, when assessing step one of the model (identify the contract), an entity also is required to consider step three of the model (determine the transaction price).

When determining the transaction price, the new standard requires an entity to determine whether credit risks that were known at contract inception represent implied price concessions (i.e., a form of variable consideration). If they do, such amounts should not be included in the estimated transaction price. Under today's guidance, rather than being reflected as a reduction of revenue, such amounts are likely shown as a component of bad debt.

However, in the Basis for Conclusions, the Boards acknowledged that in some cases, it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration. The Boards did not develop detailed guidance for distinguishing between price concessions and impairment losses. Therefore, entities should consider all relevant facts and circumstances when analyzing the nature of collectibility issues that were known at the onset of the contract.

How we see it

Entities may find it challenging to distinguish between implied price concessions (i.e., reductions of revenue) and customer credit risk (i.e., bad debt) for collectibility issues that were known at contract inception. Entities will need to carefully evaluate all facts and circumstances that were available at contract inception, as well as any subsequent events that may have affected the customer's ability to pay. Significant judgment will be required when making this determination. Entities should develop clear policies and procedures for these evaluations to ensure consistent application across all transactions.

Variable consideration also may result from extended payment terms in an arrangement and any resulting uncertainty about the entity's ability to collect those amounts in the future. That is, an entity will have to evaluate whether the extended payment terms represent an implied price concession because the entity does not intend to, or will not be able to, collect all amounts due in future periods. However, the new standard does not include the presumption that is in the current software revenue guidance that extended payment terms lead to a transaction price that is not fixed or determinable. As a result, this requirement could be less onerous for entities currently within the scope of ASC 985-605 and may accelerate the recognition of revenue for some entities.

5.1.2 Estimating variable consideration

An entity is required to estimate the transaction price using either the "expected value" or the "most likely amount" approach based on which approach better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a "free choice." Rather, an entity selects the method that is best suited based on the facts and circumstances.

The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at each reporting date. Once it selects an approach, the entity should apply that approach consistently for similar types of contracts. In the Basis for Conclusions, the Boards noted that a contract may contain different types of variable consideration and that it may be appropriate for an entity to use different approaches (i.e., expected value or most likely amount) for estimating different types of variable consideration within a single contract.

Under the expected value approach, the entity identifies the possible outcomes of a contract and the probabilities of those outcomes. The Boards indicated that the expected value approach may better predict expected consideration when an entity has a large number of contracts with similar characteristics. The Boards also clarified that an entity preparing an expected value calculation is not required to consider all possible outcomes, even if the entity has extensive data and can identify many possible outcomes. Instead, the Boards indicated in the Basis for Conclusions that, in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value.

The Boards indicated that the most likely amount approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus, but not a portion of that bonus).

The standard states that when applying either of these approaches, an entity should consider all information (historical, current and forecast) that is reasonably available to the entity. While this is not explicitly stated, the new standard implies that an entity will always have the ability to estimate the amount of variable consideration to which it will be entitled, except for sales-based royalties (see Section 5.2.1). However, the constraint on variable consideration must then be applied to the amount of variable consideration estimated (see Section 5.1.3).

How we see it

Many entities will see significant changes in how they account for variable consideration. This will be an even more significant change for entities that currently do not attempt to estimate variable consideration and simply recognize such amounts when received. We anticipate implementation questions will arise on the determination of variable consideration.

5.1.3 *Constraining estimates of variable consideration*

After estimating the amount of variable consideration within the transaction price, the entity then must apply the constraint on variable consideration. The Boards created this constraint to address concerns raised by many constituents about the possible recognition of revenue before there was sufficient certainty that the amounts would ultimately be realized.

As the following excerpt from the standard states, the constraint is aimed at preventing the over-recognition of revenue (i.e., the language focuses on potential significant reversals of revenue):

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Constraining Estimates of Variable Consideration

606-10-32-11

An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is **probable** that a significant reversal in the amount of cumulative **revenue** recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

606-10-32-12

In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

606-10-32-13

An entity shall apply paragraph 606-10-55-65 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of intellectual property.

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 determination includes considering both the likelihood and magnitude of a revenue reversal. Further, the constraint is based on the possibility of a reversal of an amount that is "significant" relative to cumulative revenue rather than only the amount of variable consideration.

For purposes of this analysis, the meaning of the term "probable" is consistent with the existing definition in US GAAP and is defined as "the future event or events are likely to occur." For IFRS preparers, the standard uses the term "highly probable," which is intended to have the same meaning as probable under US GAAP.

- Likelihood — Assessing the likelihood of a future reversal of revenue will require significant judgment, and entities will want to make sure they adequately document the basis for their conclusions. The presence of any one of the indicators cited in the excerpt above does not necessarily mean that it is probable that a change in the estimate of variable consideration will result in a significant revenue reversal. The Boards chose to provide "indicators" rather than "criteria" to signal that the list of items to consider is not a checklist for which all items have to be met. In addition, the indicators provided are not meant to be an all-inclusive list, and entities may note additional factors that are relevant in their evaluations.

- Magnitude — When assessing the probability of a significant revenue reversal, an entity also is required to assess the magnitude of that reversal relative to the total consideration (i.e., the total of variable and fixed consideration). For example, if the consideration for a single performance obligation includes both a fixed and a variable amount, the entity would assess the magnitude of a possible revenue reversal of the variable amount relative to the total consideration.

The standard includes one exception to the measurement principles of variable consideration for sales- or usage-based royalties associated with the license of intellectual property. Such amounts should not be included in the transaction price or recognized as revenue until the subsequent sales or usage occurs, as discussed further in Section 8.4. In addition, the standard provides an example of an asset management agreement that includes an incentive fee based on the return on the fund compared to the return on an observable market index over a five-year period. The example illustrates that the entity is not able to conclude that it is probable that a significant revenue reversal will not occur if the incentive fee is included in the transaction price.

There are other types of variable consideration that are frequently included in arrangements that have significant uncertainties. It will be difficult for an entity to assert it is probable that these types of estimated amounts will not be subsequently reversed. Such types of variable consideration include the following:

- Payments contingent on regulatory approval (e.g., FDA approval of a new drug)
- Long-term commodity supply arrangements that settle based on market prices at the future delivery date
- Contingency fees based on litigation or regulatory outcomes (e.g., fees based on the positive outcome of litigation or on the settlement of claims with governmental agencies)

When an entity determines that it is probable that a change in the estimate of variable consideration *would* result in a significant revenue reversal, the amount of variable consideration that must be included in the transaction price is limited to the amount that *would not* result in a significant revenue reversal. That is, an entity is required to include in the transaction price the amount of variable consideration that will not result in a significant revenue reversal when the uncertainty associated with the variable consideration is subsequently resolved.

The Boards noted in the Basis for Conclusions that an entity is not required to strictly follow a two-step process (i.e., first estimate the variable consideration and then apply the constraint to that estimate) if its internal processes incorporate the principles of both steps in a single step. For example, if an entity already has a single process to estimate expected returns when calculating revenue from the sale of goods in a manner consistent with the objectives of applying the constraint, the entity would not need to estimate revenue and then separately apply the constraint.

When an arrangement includes variable consideration, an entity should update its estimate of the transaction price throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating both the estimate of the variable consideration and the constraint on the amount of variable consideration included in the transaction price.

The following provides an illustration of the two methods for estimating the variable consideration and the effect of the constraint on both:

Illustration 5-1: Estimating variable consideration

Scenario A

Entity A provides transportation to theme park customers to and from area lodging under a one-year agreement. It is required to provide scheduled transportation throughout the year for a fixed fee of $300,000 annually. Entity A also is entitled to performance bonuses based on on-time performance and average customer wait times. Its performance may yield a bonus from $0 to $600,000 under the contract. Based on its history with the theme park and customer travel patterns and its current expectations, Entity A estimates the probabilities for different amounts of bonus within the range as follows:

Bonus amount	Probability of outcome
$ –	30%
$ 200,000	30%
$ 400,000	35%
$ 600,000	5%

Analysis

Expected value

Because Entity A believes that there is no one amount within the range that is most likely to be received, Entity A determines that the expected value approach is most appropriate. As a result, Entity A estimates variable consideration to be $230,000 ((200,000 x 30%) + (400,000 x 35%) + (600,000 x 5%)) before considering the effect of the constraint.

Assume that Entity A is a calendar year-end company, and it entered into the contract with the theme park during its second quarter. Customer wait times were slightly above average during the second quarter. Based on this experience, Entity A determines that it is probable that a significant revenue reversal for $200,000 of variable consideration will not occur. Therefore, after applying the constraint, Entity A includes only $200,000 in its estimated transaction price. At the end of its third quarter, Entity A updates its analysis and expected value calculation. The updated analysis again results in estimated variable consideration of $230,000, with a probability outcome of 75%. Based on analysis of the factors in ASC 606-10-32-12 and in light of slightly better-than-expected average customer wait times during the third quarter, Entity A determines that it is probable that a significant revenue reversal for the entire $230,000 estimated transaction price will not occur. Entity A updates its estimated transaction price to include the entire $230,000 in the transaction price. Entity A will continue to update its estimate of the transaction price at each subsequent reporting period.

Scenario B

Assume the same facts as in Scenario A, except that the potential bonus will be one of four stated amounts: $0, $200,000, $400,000 or $600,000. Based on its history with the theme park and customer travel patterns, Entity A estimates the probabilities for each bonus amount as follows:

Bonus amount	Probability of outcome
$ –	30%
$ 200,000	30%
$ 400,000	35%
$ 600,000	5%

Analysis

Expected value

Entity A determined that the expected value approach was most appropriate to use when estimating its variable consideration. Under that approach, it estimates the variable consideration is $230,000. Entity A must then consider the effect of the constraint on the amount of variable consideration included in the transaction price. Entity A notes that, because there are only four potential outcomes under the contract, the constraint essentially limits the amount of revenue Entity A can recognize to one of the stated bonus amounts. In this example, Entity A would be limited to including $200,000 in the estimated transaction price until it became probable that the next bonus level (i.e., $400,000) would be achieved. This is because any amount over $200,000 would be subject to subsequent reversal, unless $400,000 was received.

Most likely amount

Because there are only a limited number of outcomes for the amount of bonus that can be received, Entity A is concerned that a probability-weighted estimate may result in an amount that is not a potential outcome. Therefore, Entity A determines that estimating the transaction price by identifying the most likely amount would be the best predictor.

The new standard is not clear about how an entity would determine the most likely amount when there are more than two potential outcomes and none of the potential outcomes is significantly more likely than the others. A literal reading of the new standard might suggest that, in this example, Entity A should select $400,000 because that is the amount with the highest estimated probability. However, Entity A must then apply a constraint on the amount of variable consideration included in the transaction price.

To include $400,000 in the estimated transaction price, Entity A has to believe it is probable that the bonus amount will be at least $400,000. Based on the listed probabilities above, however, Entity A believes it is only 40% likely to receive a bonus of at least $400,000 and 70% likely it will receive a bonus of at least $200,000. As a result, Entity A would include only $200,000 in its estimate of the transaction price.

How we see it

We anticipate that the application of the constraint, including determining when it is probable that a significant revenue reversal would not occur, is an area for which practice issues may arise. Over time, best practices, and possibly implementation guidance, are likely to emerge regarding how entities consider the constraint on variable consideration when estimating the transaction price.

Further, applying the constraint can negate the results of the expected value calculation, as shown in Illustration 5-1.

Today's guidance has various requirements and thresholds for recognizing variable consideration. As a result, the accounting treatment varies depending on which guidance is applicable to a transaction. For example, the revenue recognition guidance in ASC 605-25 limits the recognition of contingent consideration when such amounts are contingent upon the future performance of the entity. SAB Topic 13 adds another requirement that the transaction price must be fixed or determinable in order to recognize revenue. Other guidance is less restrictive and allows entities to estimate and recognize at least portions of

the variable consideration in an arrangement. For example, under the guidance in ASC 605-20,[14] entities have the option of recognizing performance-based incentive fees on an "as if earned" basis, based on the amount due as if the contract had been terminated and the fees realized at that date (i.e., Method 2).

In contrast, the constraint on variable consideration in the new standard is an entirely new way of evaluating variable consideration and is applicable to all types of variable consideration in all transactions. As a result, depending on the guidance entities were previously applying, some entities may recognize revenue sooner under the new standard, while others may recognize revenue later. It is important to note, however, that the SEC staff has not announced how SAB Topic 13 will be affected by the new standard.

The following example illustrates how the constraint will work:

Illustration 5-2: Contingent revenue — earlier recognition than in current practice

Entity A operates outsourced call centers for retail and manufacturing companies. It is compensated through fixed minimum amounts plus variable amounts based on average customer wait times. Entity A negotiates a new three-year contract with a customer it has been serving for the past six years. The contract states that the fixed amounts payable for the annual service is $12 million per year and $10 per call for calls in excess of 1.2 million. Entity A also is able to earn annual bonus payments of $1,200,000 if the average annual customer wait time is less than four minutes.

Entity A determines that the call center service for 3.6 million calls (1.2 million calls annually) is the only performance obligation in the arrangement. That is, the option to obtain services on additional calls, because it is priced at the same rate per call as the 3.6 million calls, is not an option that provides the customer a material right. Further, based on historical experience, Entity A does not expect the volume of calls to exceed 1.2 million calls annually.

To estimate the total transaction price, Entity A would consider all reasonably available information, including its past performance on similar contracts. Based on that information, Entity A expects average wait time to be less than four minutes each year throughout the three-year contract. Therefore, the entity estimates the total transaction price as $39,600,000 (($12,000,000 x 3) + ($1,200,000 x 3)). Entity A would account for the three-year contract as a single performance obligation (see Section 4.2.2 for a discussion of identifying separate performance obligations for services) and would recognize revenue based on the proportion of calls completed to the total number of calls expected up to 1.2 million calls annually. Entity A determines that it is entitled to the full estimated transaction price because it is probable that a significant revenue reversal for that amount will not occur; thus, it would recognize as revenue $11 ($39,600,000 / 3,600,000) per call as the service is provided. Note that if Entity A expected the volume of calls to exceed 1.2 million calls in any one year, Entity A would have to include those calls (and the expected consideration) in the total transaction price so that the expected additional consideration from the calls in excess of 3.6 million is allocated across all expected calls.

Under the current guidance in SAB Topic 13, the amount considered fixed or determinable would include only the fixed minimums until the uncertainty about the bonus payments is resolved. Therefore, the entity would record $10 ($12,000,000 / 1,200,000) per call and at the end of each year would recognize the $1,200,000 bonus. This results in less revenue recorded in the first three quarters of each year (assuming the call volume is fairly even throughout the year) due to the uncertainty about the bonus payment.

The new standard provides the following example of revenue recognition for performance-based incentive fees in investment management contracts. It shows that, in some cases, revenue will be recognized later than under current practice:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 25 — Management Fees Subject to the Constraint

606-10-55-221

On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

606-10-55-222

The entity accounts for the services as a single performance obligation in accordance with paragraph 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

606-10-55-223

At contract inception, the entity considers the guidance in paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity observes that the promised consideration is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

606-10-55-224

At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception — the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. At March 31, 20X8, the client's assets under management are $100 million. Therefore, the resulting quarterly management fee and the transaction price is $2 million.

> *606-10-55-225*
>
> At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 606-10-32-28. Consequently, the entity recognizes $2 million as revenue for the quarter ended March 31, 20X8.

See Section 6 for a discussion of the allocation of the transaction price.

The new standard will change practice for many entities that sell their products through distributors or resellers. Because the sales price to the distributor or reseller may not be finalized until the product is sold to the end customer, many of these entities currently wait until the product is sold to the end customer to recognize revenue. The basis for this practice, known as the "sell-through" method, is that the sales prices is not considered "fixed or determinable," one of the general revenue recognition requirements of SAB Topic 13, until the product is sold to the end customer.

Under the new standard, this practice is no longer acceptable if the only uncertainty is the variability in the pricing. This is because the standard requires an entity to estimate the variable consideration (i.e., the end sales price) based on the information available, taking into consideration the effect of the constraint on variable consideration. That said, in some cases, the outcomes under the new and current methods may be similar.

5.2 Accounting for specific types of variable consideration

5.2.1 Sales- and usage-based royalties on the license of intellectual property

The Boards provided explicit guidance for recognizing sales- and usage-based royalties from licenses of intellectual property. Specifically, rather than follow the requirements described above, the standard includes an exception for transactions that involve sales- and usage-based royalties that result from the license of intellectual property. For those transactions, the standard states that an entity should only include such consideration in the transaction price when the subsequent sales or usage occurs. See Section 8.4 for a detailed discussion of licenses of intellectual property.

5.2.2 Rights of return

As discussed in Section 4.7, the standard says that a right of return does not represent a separate performance obligation. Instead, a right of return affects the transaction price and the amount of revenue an entity can recognize for satisfied performance obligations. In other words, rights of return create variability in the transaction price.

While the new standard's accounting treatment for rights of return may not significantly change current practice, there are some notable differences. Under the new standard, an entity will estimate the transaction price and apply the constraint to the estimated transaction price. In doing so, it will consider the products expected to be returned to determine the amount to which the entity expects to be entitled (excluding the products expected to be returned). It is unclear whether this requirement will result in a significant adjustment to an entity's returns estimated under today's accounting. The entity will recognize the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. If the entity estimates returns and applies the constraint, the portion of the revenue subject to the constraint would not be recognized until the amounts are no longer subject to the constraint, which could be at the end of the return period.

As part of updating its estimate of amounts to which it expects to be entitled in a contract, an entity must update its assessment of expected returns and the related refund liabilities. This remeasurement is performed at each financial reporting date and reflects any changes in assumptions about expected returns. Any adjustments made to the estimate will result in a corresponding adjustment to amounts recognized as revenue for the satisfied performance obligations (e.g., if the entity expects the number of returns to be lower than originally estimated, it would have to increase the amount of revenue recognized and decrease the refund liability).

Finally, when customers exercise their rights of return, the entity may receive the returned product in salable or reparable condition. Under the new standard, at the time of the initial sale (when recognition of revenue is deferred due to the anticipated return), the entity recognizes a return asset (and adjusts cost of sales) for its right to recover the goods returned by the customer. The entity initially measures this asset at the former carrying amount of the inventory, less any expected costs to recover the goods. Along with remeasuring the refund liability at each reporting date, the entity updates the measurement of the asset recorded for any revisions to its expected level of returns, as well as any potential decreases in the value of the returned products. That is, a returned item should be recognized at the lower of the original cost less the cost to recover the asset or the fair value of the asset at the time of recovery.

The balance sheet classification for amounts related to the right of return asset may be a change from current practice. Under today's guidance, the carrying value associated with any product expected to be returned typically remains in inventory, but the new guidance requires the asset to be recorded separately from inventory to provide greater transparency. In addition, the new model requires the carrying value of the return asset (i.e., the product expected to be returned) be subject to impairment testing on its own, separately from inventory on hand. Under today's guidance, expected returns frequently remain presented within inventory, and they are not subject to separate impairment testing (although when the value of returned product is expected to be zero, inventory is fully expensed at the time of sale). The new standard also requires the refund liability to be presented separately from the corresponding asset (on a gross basis rather than a net basis).

The standard provides the following example of rights of return:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 22 — Right of Return

606-10-55-202

An entity enters into 100 contracts with customers. Each contract includes the sale of 1 product for $100 (100 total products × $100 = $10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is $60.

606-10-55-203

The entity applies the guidance in this Topic to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 606-10-10-4, the effects on the financial statements from applying this guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within the portfolio.

606-10-55-204

Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

606-10-55-205

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $9,700 ($100 × 97 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (that is, the 30-day return period). Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $9,700) will not occur as the uncertainty is resolved (that is, over the return period).

606-10-55-206

The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

606-10-55-207

Upon transfer of control of the 100 products, the entity does not recognize revenue for the 3 products that it expects to be returned. Consequently, in accordance with paragraphs 606-10-32-10 and 606-10-55-23, the entity recognizes the following:

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

How we see it

The topic of product sales with rights of return within the new revenue standard is one that has not received as much attention as some of the other topics for a variety of reasons. However, the changes in this area (primarily treating the right of return as a type of variable consideration that must be put through the variable consideration model, including the constraint) may affect manufacturers and retailers that otherwise may not be significantly affected by the new guidance. Entities will have to assess whether their current models for estimating returns are appropriate, given the need to consider the constraint. This is another example where the methodology has changed but the outcome may be similar to today's guidance.

5.3 Significant financing component

For certain transactions, the receipt of consideration does not match the timing of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid well after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

The standard states the following in relation to a significant financing component in a contract:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

The Existence of a Significant Financing Component in the Contract

606-10-32-15

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the **contract** (either explicitly or implicitly) provides the **customer** or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

606-10-32-16

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize **revenue** at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services

b. The combined effect of both of the following:

   1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services

   2. The prevailing interest rates in the relevant market.

606-10-32-17

Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.

b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

606-10-32-18

As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

An entity is not required to assess whether the arrangement contains a significant financing component unless the period between the customer's payment and the entity's transfer of the goods or services is greater than one year. It is not entirely clear in the standard whether entities should make this assessment at the contract level or at the performance obligation level. In addition, it is not clear how an entity that has an arrangement with more than one performance obligation should treat the financing. Questions remain about whether the entity should allocate the effects of the financing to only those performance obligations that are financed and not to the performance obligations that are not financed. That is, it is difficult to tell whether an entity should determine whether it has a financing component at the contract level but then allocate the financing amounts at the performance obligation level.

Further, unless the financing component is considered significant to the contract, entities will not be required to adjust the transaction price for this component. The assessment of significance is done at the individual contract level. The Boards decided that it would be an undue burden to require an entity to account for a financing component if the effects of the financing component are not material to the individual contract but the combined effects of the financing components for a portfolio of similar contracts would be material to the entity as a whole.

There likely will be significant judgment involved in determining whether a significant financing component exists when there is more than one year between the transfer of goods or services and the receipt of arrangement consideration. Entities will need to make sure that they have sufficiently documented their analyses to support their conclusions.

When an entity concludes that a financing component is significant to a contract, it determines the transaction price by discounting the amount of promised consideration. The entity uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The discount rate has to reflect the credit characteristics of the borrower in the arrangement; using the risk-free rate or a rate explicitly stated in the contract that does not correspond with a separate financing rate would not be acceptable. While this is not explicitly stated in the model, we believe an entity has to consider the expected term of the financing when determining the discount rate in light of current market conditions at contract inception. The entity should not update the discount rate for changes in circumstances or interest rates after contract inception.

The standard includes the following examples to illustrate these concepts:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 26 — Significant Financing Component and Right of Return

606-10-55-227

An entity sells a product to a customer for $121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new, and the entity has no relevant historical evidence of product returns or other available market evidence.

606-10-55-228

The cash selling price of the product is $100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is $80.

606-10-55-229

The entity does not recognize revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, revenue is recognized after three months when the right of return lapses.

606-10-55-230

The contract includes a significant financing component, in accordance with paragraph 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.

606-10-55-231

The contract includes an implicit interest rate of 10 percent (that is, the interest rate that over 24 months discounts the promised consideration of $121 to the cash selling price of $100). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs 606-10-55-22 through 55-29:

a. When the product is transferred to the customer, in accordance with paragraph 606-10-55-23.

Asset for right to recover product to be returned	$ 80[(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	
Asset for product to be returned	$ 80	

(b) The Receivable recognized would be measured in accordance with Topic 310 on receivables. This Example does not consider the impairment accounting for the receivable

606-10-55-232

Until the entity receives the cash payment from the customer, interest income would be recognized consistently with the subsequent measurement guidance in Subtopic 835-30 on imputation of interest. The entity would accrete the receivable up to $121 from the time the right of return lapses until customer payment.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 28 — Determining the Discount Rate

606-10-55-235

An entity enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is $1 million plus a 5 percent contractual rate of interest, payable in 60 monthly installments of $18,871.

Case A — Contractual Discount Rate Reflects the Rate in a Separate Financing Transaction

606-10-55-236

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent reflects the credit characteristics of the customer).

606-10-55-237

The market terms of the financing mean that the cash selling price of the equipment is $1 million. This amount is recognized as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.

Case B — Contractual Discount Rate Does Not Reflect the Rate in a Separate Financing Transaction

606-10-55-238

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest is significantly lower than the 12 percent interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than $1 million.

606-10-55-239

In accordance with paragraph 606-10-32-19, the entity determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 12 percent interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is $848,357 (60 monthly payments of $18,871 discounted at 12 percent). The entity recognizes revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.

How we see it

The standard requires that the discount rate be a rate similar to what the entity would have used in a separate financing transaction with the customer. Because most entities are not in the business of entering into freestanding financing arrangements with their customers, they may find it difficult to identify an appropriate rate. However, most entities perform some level of credit analysis before financing purchases for a customer, so they will have some information about the customer's credit risk. For entities that have different pricing for products depending on the time of payment (e.g., cash discounts), the standard indicates that the appropriate discount rate could be determined by identifying the rate that discounts the nominal amount of the promised consideration to the cash sales price of the good or service.

5.3.1 *Financial statement presentation of financing component*

The financing component of the transaction price should be presented separately from the revenue recognized. Upon satisfaction of the performance obligations, an entity should recognize the present value of the promised consideration as revenue. The financing component is recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). The interest income or expense is recognized over the financing period using the interest method described in ASC 835, *Interest*. The Boards noted that an entity may present interest income as revenue only when interest income represents income from an entity's ordinary activities (e.g., banks that regularly enter into financing transactions and have other interest income that represents income arising from ordinary activities).

Receivables with a financing component are considered to be long-term receivables. Although both long- and short-term receivables arise from transactions with a customer, the presentation of long- and short-term receivables will differ on the income statements. The presentation of any impairment losses on a long-term receivable is consistent with the presentation for other financial assets in the scope of the financial instruments guidance. The presentation of impairment losses on short-term receivables or contract assets is reflected as a separate line item in operating expense in the statement of comprehensive income.

5.4 Noncash consideration

Customer consideration might be in the form of goods, services or other noncash consideration. When an entity (i.e., the seller or vendor) receives, or expects to receive, noncash consideration, the fair value of the noncash consideration is included in the transaction price.[15] An entity applies the principles of ASC 820[16] in measuring the fair value of the noncash consideration. If an entity cannot reasonably estimate the fair value of noncash consideration, it should measure the noncash consideration indirectly by reference to the estimated standalone selling price of the promised goods or services.

The concept of accounting for noncash consideration at the fair value of the noncash consideration received is a change from today's guidance, whereby, unless certain exceptions are met, an entity first looks to the fair value of the goods or services surrendered and then to the fair value of the asset acquired if it was more clearly evident. Under the new standard, the order is reversed. That is, an entity first considers the fair value of the goods or services received and only considers the fair value (i.e., selling price) of the goods or services surrendered if the fair value of what was received is not reasonably estimable. As a result, an entity's measurement of noncash consideration received from a customer may differ from the customer's measurement of the same noncash consideration granted. In addition, under today's guidance, if any of the exceptions for recognizing a transaction at fair value within ASC 845 are met, the noncash consideration surrendered would be measured at its carrying amount. This concept is not included in the new standard.

The new guidance does not contain the prescriptive guidance for advertising barter transactions in today's guidance. Therefore, more judgment about the specific facts and circumstances will be necessary when accounting for advertising barter transactions.

For contracts with both noncash and cash consideration, an entity only will need to measure the fair value of the noncash consideration and will look to other guidance within the revenue standard for the cash consideration. For example, in a contract when an entity receives noncash consideration and a sales-based royalty, the entity would measure the fair value of the noncash consideration and look to the requirements within the new standard for sales-based royalties.

The fair value of noncash consideration could change because of the occurrence or nonoccurrence of a future event or because of the form of consideration (e.g., a change in the price of a share an entity is entitled to receive from a customer). Under the new standard, if the noncash consideration promised by a customer is variable for reasons other than just the form of consideration (i.e., there is uncertainty as to whether the entity will receive the noncash consideration), the entity should consider the constraint on variable consideration.

In some transactions, a customer contributes goods or services, such as equipment or labor, to facilitate the fulfillment of the contract. If the entity obtains control of the contributed goods or services, it should consider them noncash consideration and account for that consideration as described above.

The Boards also noted that any asset recognized as a result of noncash consideration would be accounted for in accordance with other relevant guidance (e.g., ASC 320[17]).

The standard provides the following example of noncash consideration:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 31 — Entitlement to Noncash Consideration

606-10-55-248

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on January 1, 20X1, and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

606-10-55-249

In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

606-10-55-250

The entity measures its progress toward complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognized), the entity measures the fair value of 100 shares that are received upon completion of each weekly service. The entity does not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

5.5 Consideration paid or payable to a customer

Many entities also make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

The new standard provides the following guidance for consideration paid or payable to a customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Consideration Payable to a Customer

606-10-32-25

Consideration payable to a **customer** includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the **transaction price** and, therefore, of **revenue** unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

606-10-32-26

If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

606-10-32-27

Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

a. The entity recognizes revenue for the transfer of the related goods or services to the customer.

b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

The standard states that an entity should account for the consideration payable to a customer, regardless of whether the purchaser receiving the consideration is a direct or indirect customer of the entity. This includes consideration payable to any purchasers of the entity's products at any point along the distribution chain. The requirements also apply to entities that derive revenue from sales of services, as well as entities that derive revenue from sales of goods.

Consideration paid or payable to customers commonly takes the form of discounts, coupons, free products or services, and equity instruments, among other things. In addition, some entities make payments to the customers of resellers or distributors that purchase directly from the entity (e.g., manufacturers of breakfast cereals offer coupons to consumers, even though their direct customers are the grocery stores that sell to consumers). Further, the promise to pay the consideration might be implied by the entity's customary business practice. To determine the appropriate accounting treatment, an entity must first determine whether the consideration paid or payable to a customer is a payment for a distinct good or service, a reduction of the transaction price or a combination of both.

For a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct (as discussed in Section 4.2).

If the consideration paid or payable to a customer is a discount or refund for goods or services provided to a customer, this reduction of the transaction price (and thus revenue) should be recognized at the later of when the entity transfers the promised goods or services to the customer or the entity promises to pay the consideration. This is true even if the payment is conditional on a future event. For example, if goods subject to a discount through a coupon are already delivered to the retailers, the discount would be recognized when the coupons are issued. However, if a coupon is issued that can be used on a new line of products that have not yet been sold to retailers, the discount would be recognized upon sale of the product to a retailer.

If the consideration paid or payable to a customer includes variable consideration in the form of a discount or refund for goods or services provided, an entity would use either the expected value approach or most likely amount to estimate the amount to which the entity expects to be entitled to and apply the constraint to the estimate (see Section 5.1 for further discussion) to determine the effect of the discount or refund.

However, the guidance on the timing of when consideration payable to a customer should be recognized appears to be inconsistent with the requirements to consider implied price concessions as variable consideration. That is, the standard's definition of variable consideration is broad enough to include amounts such as coupons or other forms of credits that can be applied to the amounts owed. That guidance requires that all potential variable consideration be considered and reflected in the transaction price at inception and as the

entity performs. In other words, if an entity has a history of providing this type of consideration to its customers, the guidance on estimating variable consideration suggests that such amounts should be considered at the inception of the arrangement, even if the entity hasn't yet provided this consideration to the customer.

The inconsistency arises as the guidance specific to "consideration payable to a customer" states that such amounts should not be recognized as a reduction of revenue until the *later* of when the related sales are recognized or the entity makes the promise to provide such consideration. This seems to suggest that an entity should not anticipate that it may offer these types of programs, even if it has a history of doing so, and should only recognize the effect of these programs at the later of when the entity transfers the promised goods or services or makes a promise to pay the customer. We hope that further guidance will be provided to provide a resolution to this inconsistency.

Because consideration paid to a customer can take many different forms, entities will have to carefully evaluate each transaction to determine the appropriate treatment of such amounts. Some common examples of consideration paid to a customer include:

Slotting fees — Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Those shelves can be physical (i.e., in a building where the store is located) or virtual (i.e., they represent space in an internet reseller's online catalog). Generally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

Cooperative advertising arrangements — In some arrangements, a vendor agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the vendor's products. The determination of whether the payment from the vendor is in exchange for a distinct good or service at fair value will depend on a careful analysis of the facts and circumstances of the arrangements.

Buy downs or price protection — A vendor may agree to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the vendor's products over a specified period of time. Normally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

Coupons and rebates — An indirect customer of a vendor may receive a refund of a portion of the purchase price of the product or service acquired by returning a form to the retailer or the vendor. Generally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

"Pay to play" arrangements — In some arrangements, an entity pays an up-front fee to the customer in order to obtain a new contract. In most cases, these payments are not associated with any distinct good or service to be received from the customer and should be treated as a reduction of the transaction price.

Purchase of goods or services — Entities often enter into supplier-vendor arrangements with their customers in which the customers provide them with a distinct good or service. For example, a software entity may buy its office supplies from one of its software customers. In such situations, the entity has to carefully determine whether the payment made to the customer is solely for the goods and services received, or whether part of the payment is actually a reduction of the transaction price for the goods and services the entity is transferring to the customer.

The new standard's accounting for consideration payable to a customer is generally consistent with today's guidance. However, the determination of whether a good or service is "distinct" may differ from today's requirement under US GAAP to determine whether the vendor has received an "identifiable benefit" from the customer in order to treat the consideration payable to a customer as anything other than a reduction of revenue. When today's guidance on this topic was written, the intent was for the guidance to have a very broad application. This has caused some transactions that likely weren't contemplated to be revenue transactions to be in the scope of the guidance. Today's guidance requires entirely separate transactions to be considered when applying the guidance. For example, if an entity makes contributions to a charitable organization and the charity is also a customer of the entity, the contributions are likely within the scope of today's guidance. In the Basis for Conclusions, the Boards note that the amount of consideration received from a customer for goods or services, and the amount of any consideration paid to that customer for goods or services, could be linked even if they are separate events. Because the new guidance uses similar language, but not the exact words that are in today's guidance, it is unclear whether the Boards intended the new guidance to apply as broadly as today's guidance.

The standard includes the following example of consideration paid to a customer:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 32 — Consideration Payable to a Customer

606-10-55-252

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least $15 million of products during the year. The contract also requires the entity to make a nonrefundable payment of $1.5 million to the customer at the inception of the contract. The $1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

606-10-55-253

The entity considers the guidance in paragraphs 606-10-32-25 through 32-27 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 606-10-32-25, the $1.5 million payment is a reduction of the transaction price.

606-10-55-254

The entity applies the guidance in paragraph 606-10-32-27 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognizes revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 percent ($1.5 million ÷ $15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognizes revenue of $1.8 million ($2.0 million invoiced amount — $0.2 million of consideration payable to the customer).

5.6 Nonrefundable up-front fees

In certain circumstances, entities may receive payments from customers before they provide the contracted service or deliver a good. Up-front fees generally relate to the initiation, activation or setup of a good to be used, or a service to be provided, in the future. Up-front fees also may be paid to grant access to, or to provide a right to use, a facility, product or service. In many cases, the up-front amounts paid by the customer are nonrefundable. Examples include fees paid for membership to a health club or buying club and activation fees for phone, cable or internet services.

Entities must evaluate whether nonrefundable up-front fees relate to the transfer of a good or service. In many situations, an up-front fee represents an advance payment for future goods or services. In addition, the existence of a nonrefundable up-front fee may indicate that the arrangement includes a renewal option for future goods and services at a reduced price (if the customer renews the agreement without the payment of an additional up-front fee).

Illustration 5-3: Nonrefundable up-front fees

A customer signs a one-year contract with a health club and is required to pay both a nonrefundable initiation fee of $150 and an annual membership fee in monthly installments of $40. The club's activity of registering the customer does not transfer any service to the customer and, therefore, is not a performance obligation. By not requiring the customer to pay the up-front membership fee again at renewal, the club is effectively providing a discounted renewal rate to the customer.

The club determines that the renewal option is a material right because it provides a renewal option at a lower price than the range of prices typically charged, and therefore, it is a separate performance obligation. Based on its experience, the club determines that its customers, on average, renew their annual memberships twice before terminating their relationship with the club. As a result, the club determines that the option provides the customer with the right to two annual renewals at a discounted price. In this scenario, the club would allocate the total transaction consideration of $630 ($150 up-front membership fee + $480 ($40 x 12 months)) to the identified performance obligations (monthly services and renewal option) based on the relative standalone selling price method. The amount allocated to the renewal option would be recognized as each of the two renewal periods is either exercised or forfeited.

Alternatively, the club could value the option by "looking through" to the optional goods and services. In that case, the club would determine that the total transaction price is the sum of the up-front fee plus three years of monthly service fees (i.e., $150 + $1,440) and would allocate that amount to all of the services expected to be delivered, or 36 months of membership (or $44.17 per month).

See Section 4.6 for a more detailed discussion of the treatment of options.

6 Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price to the performance obligations. This is generally done in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). As a result, any discount within the contract generally is allocated proportionally to all of the separate performance obligations in the contract.

However, as discussed further below, there are some exceptions. For example, an entity could allocate variable consideration to a single performance obligation in some situations. The standard also contemplates the allocation of any discount in an arrangement to only certain performance obligations, if specified criteria are met.

6.1 Estimating standalone selling prices

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price for each performance obligation. Under the new standard, this is the price at which an entity would sell a good or service on a standalone basis at contract inception.

Under the model, the observable price of a good or service sold separately 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.

The estimate of standalone selling prices is performed at contract inception and is not updated to reflect changes between contract inception and when performance is complete. For example, if an entity determines the standalone selling price for a promised good, and before it can manufacture and deliver that good, the underlying cost of the materials doubles, the entity would not revise its estimate of the standalone selling price for purposes of this arrangement. However, for future arrangements involving the same good, the entity would need to use a revised standalone selling price (see Section 6.1.3). Further, if the contract is modified, and the modification is not treated as a separate contract (see Section 6.5), the entity would update its estimates of standalone selling prices at the time of the modification.

The requirement to estimate a standalone selling price will not be a new concept for entities that currently apply the multiple-element arrangements guidance in ASC 605-25. The new guidance on estimating a standalone selling price is generally consistent with ASC 605-25 except that it doesn't require an entity to consider a hierarchy of evidence to make this estimate.

Some entities have adopted the provisions of ASC 605-25 by developing estimates of selling prices for elements within an arrangement that may exhibit "highly variable" pricing as described below. The new standard may allow those entities to revert to a residual approach similar to the accounting for these elements before the FASB issued what was then new multiple-element guidance in 2009.

The requirement to estimate a standalone selling price may be a significant change for entities that currently follow the software revenue recognition guidance in ASC 985-605. That literature has a different threshold for determining the standalone selling price, requiring observable evidence and not management estimates. Some of these entities may find it difficult to determine a standalone selling price, particularly for goods or services that are never sold separately (e.g., specified upgrade rights for software). In certain circumstances, an entity may be able to estimate the standalone selling price of a performance obligation using a residual approach. (See Section 6.1.2) In these cases, the results would likely be similar to circumstances when current practice requires a residual approach.

How we see it

Entities that don't currently estimate standalone selling prices will likely need to involve personnel beyond those in the accounting or finance departments. We anticipate personnel responsible for an entity's revenue recognition policies will need to consult with operating personnel involved in an entity's pricing decisions in order to determine estimated standalone selling prices, especially when there are limited or no observable inputs.

For purposes of estimating standalone selling price, the standard provides the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocation Based on Standalone Selling Prices

606-10-32-33

If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.

606-10-32-34

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

a. Adjusted market assessment approach — An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

b. Expected cost plus a margin approach — An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

c. Residual approach — An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:

    1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).

    2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

6.1.1 Factors to consider when estimating the standalone selling price

The standard states that when estimating the standalone selling price, an "entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity." This is a very broad requirement and will require an entity to consider a variety of data sources.

While not an all-inclusive list, the following are examples of market conditions to consider:

- Potential limitations to the selling price of the product
- Competitor pricing for a similar or identical product
- Market awareness of and perception of the product
- Current market trends that will likely affect the pricing
- The entity's market share and position (e.g., the entity's ability to dictate pricing)
- Effects of the geographic area on pricing
- Effects of customization on pricing
- Expected technological life of the product

Examples of entity-specific factors include:

- Profit objectives and internal cost structure
- Pricing practices and pricing objectives (including desired gross profit margin)
- Effects of customization on pricing
- Pricing practices used to establish pricing of bundled products
- Effects of a proposed transaction on pricing (e.g., the size of the deal, the characteristics of the targeted customer)
- The expected technological life of the product, including significant vendor-specific technological advancements expected in the near future

An entity's documentation of its estimated standalone selling price, especially in situations in which there is limited or no observable data, will need to be sufficiently robust to demonstrate how it considered the types of factors listed above in reaching its estimate.

6.1.2 Possible estimation methods

The standard discusses three estimation methods: (1) the adjusted market assessment approach, (2) the expected cost plus a margin approach and (3) a residual approach, all of which are discussed further below. When applying the standard, an entity may need to use a combination of these methods to estimate a standalone selling price. Further, these are not the only estimation methods permitted. The standard allows any reasonable estimation method as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs, and is applied on a consistent basis for similar goods and services and customers.

In some cases, an entity may have sufficient observable data to determine the standalone selling price. For example, an entity may have sufficient standalone sales of a particular good or service that give it persuasive evidence of the standalone selling price of a particular good or service. In such situations, no estimation would be necessary.

If an entity does not have sufficient standalone sales data to determine the standalone selling price based solely on those standalone sales, it must maximize the use of whatever observable inputs it has available to make its estimate. In other words, an entity should not disregard any observable inputs when estimating the standalone selling price of a good or service.

To make this estimate, an entity may use one or a combination of the following methods mentioned in the standard:

Adjusted market assessment approach — This approach focuses on the amount that the entity believes the market is willing to pay for a good or service. This approach is based primarily on external factors rather than the entity's own internal influences. When using the adjusted market assessment approach, an entity should consider market conditions, such as those listed in Section 6.1.1. Applying this approach will likely be easiest when an entity has sold the good or service for a period of time (so it has data about customer demand) or a competitor offers similar goods or services that the entity can use as a basis for its analysis. Applying this approach may be difficult when an entity is selling an entirely new good or service because it may be difficult to anticipate market demand. In such situations, we anticipate entities may want to use the market assessment approach in combination with other approaches to maximize the use of observable inputs (e.g., the market assessment approach combined with an entity's planned internal pricing strategies if the performance obligation has never been sold separately).

Expected cost plus margin approach — This approach focuses more on internal factors (e.g., the entity's cost basis) but has an external component as well. That is, the margin included in this approach must reflect the margin the market would be willing to pay, not just the entity's desired margin. The margin may have to be adjusted for differences in products, geographies, customers and other factors. The expected cost plus margin approach may be useful in many situations, especially when the performance obligation has a determinable, direct fulfillment cost (see Section 8.3.2). However, this approach may be less helpful when there are no clearly identifiable direct fulfillment costs or the amount of those costs is unknown.

Residual approach — The residual approach allows an entity that can estimate the standalone selling prices for one or more, but not all, of the promised goods or services to allocate the remainder of the transaction price, or the residual amount, to the goods or services for which it could not reasonably make an estimate. Because the standard indicates that this method can be applied for multiple-element transactions when the selling price of one or more goods or services is unknown, either because the historical selling price was highly variable or because the goods or services have not yet been sold, we anticipate the use of this method likely will be limited. However, allowing entities to use a residual technique will provide relief to those that rarely or never sell goods or services on a standalone basis, such as entities that sell intellectual property only with physical goods or services. An example would be an entity that frequently sells software, professional services and maintenance bundled together at prices that vary widely and also sells the professional services and maintenance deliverables individually at relatively stable prices. The Boards indicated that it may be appropriate to estimate the standalone selling price for the software as the difference between the total transaction price and the estimated selling price of the professional services and maintenance. See Example 34, Cases B and C, in Section 6.4 for examples of when the residual approach may or may not be appropriate.

The standard indicates that an entity may have to use a combination of these (or other) methods to develop an estimate of the standalone selling price and cites situations in which two or more performance obligations have highly variable or uncertain standalone pricing. For example, if an entity enters into an arrangement with five performance obligations, two of which have highly variable pricing, the entity may use the residual approach to determine the total value to allocate to the two highly variable performance obligations, and then it may use another approach to determine how to allocate that total amount between the two.

Regardless of whether the entity uses a single method or a combination of methods to estimate the standalone selling price, the entity should evaluate whether the resulting allocation of the transaction price is consistent with the overall allocation objective[18] and the guidance on estimating standalone selling prices.[19]

In accordance with the standard, an entity must make a reasonable estimate of the standalone selling price for each performance obligation. In developing this requirement, the Boards believed that, even in instances in which limited information is available, entities should have sufficient information to develop a reasonable estimate.

How we see it

Estimating standalone selling price may require a change in practice. Entities will no longer have to follow the hierarchy in today's ASC 605-25 guidance that requires them to consider VSOE, then third-party evidence and then best estimate of selling price. In addition, entities that follow today's ASC 985-605 will no longer be required to establish VSOE of fair value based on a significant majority of their transactions. As a result, we expect that entities may use different methods than they do today to estimate standalone selling prices. However, because these estimates may have limited underlying observable data, it will be important for entities to have robust documentation to demonstrate the reasonableness of the calculations they make in estimating standalone selling prices. How much the results will vary in comparison to today's guidance is not known.

6.1.3 Updating estimated standalone selling prices

The standard does not directly address how frequently estimated standalone selling prices must be updated. Instead, it indicates that an entity must make this estimate for each transaction (suggesting constant updating). In practice, we anticipate that entities will be able to consider their facts and circumstances in order to determine how frequently they will need to update their estimates. For example, if the information used to estimate the standalone selling price for similar transactions hasn't changed, an entity may determine that it is reasonable to use the previously determined standalone selling price. However, to ensure that changes in circumstances are reflected in the estimate in a timely manner, we anticipate that an entity would formally update the estimate on a regular basis (e.g., quarterly, semiannually). The frequency of updates should be based on the facts and circumstances of the performance obligation for which the estimate is made. An entity should use current information each time it develops or updates its estimate, and the method used to estimate standalone selling price should not change (i.e., an entity must use a consistent approach) unless facts and circumstances change.

6.1.4 Additional considerations for determining the standalone selling price

While not explicit in the standard, we anticipate that a single good or service could have more than one standalone selling price. That is, the entity may be willing to sell goods or services at different prices to different customers. Further, an entity may use different prices in different geographies or in markets where it uses different methods to distribute its products (e.g., use of a distributor or reseller versus selling directly to the end customer). Accordingly, an entity may need to stratify its analysis to determine its standalone selling price for each class of customer.

In addition, it may be appropriate, depending on the facts and circumstances, for an entity to develop a reasonable range for its estimated standalone selling price rather than a single estimate.

When an entity must estimate the standalone selling price, the model requires that the entity not presume that a contractually stated price or a list price for a good or service is the standalone selling price.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 33 — Allocation Methodology

606-10-55-256

An entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately, and, therefore the standalone selling price is directly observable. The standalone selling prices of Products B and C are not directly observable.

606-10-55-257

Because the standalone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the standalone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximizes the use of observable inputs (in accordance with paragraph 606-10-32-33). The entity estimates the standalone selling prices as follows:

Product	Standalone selling price	Method
Product A	$ 50	Directly observable (see paragraph 606-10-32-32)
Product B	25	Adjusted market assessment approach (see paragraph 606-10-32-34(a))
Product C	75	Expected cost plus a margin approach (see paragraph 606-10-32-34(b))
Total	$ 150	

606-10-55-258

The customer receives a discount for purchasing the bundle of goods because the sum of the standalone selling prices ($150) exceeds the promised consideration ($100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs (in accordance with paragraph 606-10-32-37) and concludes that it does not. Consequently, in accordance with paragraphs 606-10-32-31 and 606-10-32-36, the discount is allocated proportionately across Products A, B, and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated transaction price	
Product A	$ 33	($50 ÷ $150 × $100)
Product B	17	($75 ÷ $150 × $100)
Product C	50	($75 ÷ $150 × $100)
Total	$ 100	

6.1.5 *Measurement of options that are separate performance obligations*

An entity that determines that an option is a separate performance obligation (because the option provides the customer with a material right, as discussed further in Section 4.6) has to determine the standalone selling price of the option. If the option's standalone selling price is not directly observable, the entity estimates it, taking into consideration the discount the customer would receive in a standalone transaction and the likelihood that the customer would exercise the option.

The standard provides an alternative to estimating the standalone selling price of an option if that amount is not observable. This practical alternative applies when the goods or services are both (1) similar to the original goods and services in the contract and (2) provided in accordance with the terms of the original contract. The standard indicates this alternative generally will cover options for contract renewals. Under this alternative, instead of valuing the option itself, an entity can assume the option is going to be exercised by including the optional additional goods and services with the performance obligations already identified in the contract and including the consideration related to the optional goods or services in the estimated transaction price.

The requirement to allocate arrangement consideration to an option on a relative standalone selling price basis is consistent with the current guidance in ASC 605-25. However, ASC 605-25 requires the entity to estimate the selling price of the option (unless other objective evidence of the selling price exists) and does not provide the alternative method of assuming the option is exercised.

The following example illustrates the two possible approaches for valuing options included in an arrangement:

Illustration 6-1: Accounting for an option

An aftermarket home warranty provider offers a promotion to new subscribers who pay full price for the first year of coverage that would grant them an option to renew their services for up to two years at a discount. The entity regularly sells warranty coverage for $750 per year. With the promotion, the customer would be able to renew the one-year warranty at the end of each year for $600. The entity concludes that the ability to renew is a material right because the customer would receive a discount that exceeds any discount available to other customers. The entity also determines that no directly observable standalone selling price exists for the option to renew at a discount.

Scenario A — Estimate the standalone selling price of the option

Because the entity has no directly observable evidence of the standalone selling price for the renewal option, the entity has to estimate the standalone selling price of an option for a $150 discount on the renewal of service in years two and three. In developing its estimate, the entity would likely consider factors such as the likelihood that the option will be exercised, the time value of the money because the discount is only available in future periods and the price of comparable discounted offers. For example, the entity may consider the selling price of an offer for a discounted price of similar services found on a "deal of the day" website.

The option would then be included in the relative standalone selling price allocation. In this example, there would be two performance obligations, one year of warranty services and one option for discounted renewals. The arrangement consideration of $750 would be allocated between those two distinct performance obligations based on their relative standalone selling prices.

Scenario B — Assume the exercise of the option

If the entity chooses to evaluate the transaction assuming the customer will exercise the option, it includes the proceeds associated with the option exercise in the transaction price and includes the optional service periods in the identified performance obligations.

Assume the entity obtained 100 new subscribers under the promotion. Based on its experience, the entity anticipates approximately 50% attrition annually, after also giving consideration to the anticipated effect that the $150 discount will have on attrition. The entity concludes that it is probable that a significant revenue reversal will not occur. Therefore, the entity concludes that for this portfolio of contracts, it will ultimately sell 175 one-year warranty services (100 + 50 renewals after year one + 25 renewals after year two).

The total consideration the entity expects to receive is $120,000 [(100 x $750) + (50 x $600) + (25 x $600)]. Assuming the standalone selling price for each warranty period is the same, the entity allocates $685.71 ($120,000/175) to each warranty period sold.

The entity would recognize revenue related to the warranty services as the services are performed. During the first year, the entity would recognize revenue of $68,571 (100 warranties sold times the allocated price of $685.71 per warranty) and deferred revenue of $6,429 ($75,000 cash received less $68,571 revenue recognized).

If the actual renewals in years two and three differ from expectations, the entity would have to update its estimates.

6.2 Applying the relative standalone selling price method

Once an entity has determined the standalone selling price for the distinct goods and services in an arrangement, the entity allocates the transaction price to those performance obligations. The standard requires an entity to use the relative standalone selling price method to allocate the transaction price except in the two specific circumstances that are described in Sections 6.3 and 6.4.

Under the relative standalone selling price method, the transaction price is allocated to each separate performance obligation based on the proportion of the standalone selling price of each performance obligation to the sum of the standalone selling prices of all of the performance obligations in the contract.

The requirements of the new standard are not significantly different from today's guidance where it requires a relative selling price allocation. As a result, we generally do not expect the allocation of the transaction price to change significantly for entities that already perform relative selling price allocations. However, that may not be the case if an entity applies one or both of the exceptions provided in the model (described in Sections 6.3 and 6.4). Further, some entities may not be applying a relative selling price allocation under today's GAAP (e.g., those entities currently required to apply a residual method). The new requirements likely will represent a significant change for those entities.

We have provided the following example of a relative standalone selling price allocation:

Illustration 6-2: Relative standalone selling price allocation

Manufacturing Co. enters into a contract with a customer to sell a machine for $100,000. The total contract price includes installation of the machine and a two-year extended warranty. Assume Manufacturing Co. determined there were three distinct performance obligations, and the standalone selling prices of those performance obligations were as follows: machine — $75,000, installation services — $14,000, and extended warranty — $20,000.

The aggregate of the standalone selling prices ($109,000) exceeds the total transaction price of $100,000, indicating there is a discount inherent in the arrangement. That discount must be allocated to each of the individual performance obligations based on the relative standalone selling price of each performance obligation. Therefore, the amount of the $100,000 transaction price is allocated to each performance obligation as follows:

Machine — $68,800 ($75,000 x ($100,000/$109,000))
Installation — $12,850 ($14,000 x ($100,000/$109,000))
Warranty — $18,350 ($20,000 x ($100,000/$109,000))

The entity would recognize as revenue the amount allocated to each performance obligation when (or as) each performance obligation is satisfied.

6.3 Allocating variable consideration

The new standard provides two exceptions to the relative standalone selling price method to allocate the transaction price.

The first relates to the allocation of variable consideration (see Section 6.4 for the second exception). This exception allows 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 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 (see Section 4.2.2). The standard allows for this exception to be applied to a single performance obligation or a combination of performance obligations or distinct goods or services that make up part of a performance obligation.

Two criteria must be met to apply this exception, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocation of Variable Consideration

606-10-32-39

Variable consideration that is promised in a **contract** may be attributable to the entire contract or to a specific part of the contract, such as either of the following:

a. One or more, but not all, **performance obligations** in the contract (for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time)

b. One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

606-10-32-40

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).

b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

606-10-32-41

The allocation requirements in paragraphs 606-10-32-28 through 32-38 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 606-10-32-40.

While the language excerpted from ASC 606-10-32-40 implies this exception is limited to a single performance obligation or a single distinct good or service, the preceding paragraph indicates that the variable consideration can be allocated to "one or more, but not all, performance obligations." We understand that the Boards chose to use a drafting convention throughout the standard to use a singular reference rather than continuing to repeat "one or more, but not all" for the remainder of the discussion. This understanding is consistent with ASC 606-10-32-39.

The Boards noted in the Basis for Conclusions that this exception is necessary because there may be transactions in which allocating contingent amounts to all performance obligations in a contract provides a result that does not reflect the economics of the transaction. In such situations, allocating variable consideration entirely to a distinct good or service may be appropriate when the amount allocated to that particular good or service is reasonable relative to all other performance obligations and payment terms in the contract. Subsequent changes in variable consideration should be allocated in a consistent manner.

It is important to note that allocating variable consideration to one or more, but not all, performance obligations is a requirement, not a policy election. If the above criteria are met, the entity must allocate the variable consideration to the related performance obligation(s).

The standard provides the following example to illustrate when an entity may or may not be able to allocate variable consideration to a specific part of a contract. (Note, the example focuses on licenses of intellectual property, which is discussed in Section 8.4):

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 35 — Allocation of Variable Consideration

606-10-55-270

An entity enters into a contract with a customer for two intellectual property licenses (Licenses X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The standalone selling prices of Licenses X and Y are $800 and $1,000, respectively.

Case A — Variable Consideration Allocated Entirely to One Performance Obligation

606-10-55-271

The price stated in the contract for License X is a fixed amount of $800, and for License Y the consideration is 3 percent of the customer's future sales of products that use License Y. For purposes of allocation, the entity estimates its sales-based royalties (that is, the variable consideration) to be $1,000, in accordance with paragraph 606-10-32-8.

606-10-55-272

To allocate the transaction price, the entity considers the criteria in paragraph 606-10-32-40 and concludes that the variable consideration (that is, the sales-based royalties) should be allocated entirely to License Y. The entity concludes that the criteria in paragraph 606-10-32-40 are met for the following reasons:

a. The variable payment relates specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y).

b. Allocating the expected royalty amounts of $1,000 entirely to License Y is consistent with the allocation objective in paragraph 606-10-32-28. This is because the entity's estimate of the amount of sales-based royalties ($1,000) approximates the standalone selling price of License Y and the fixed amount of $800 approximates the standalone selling price of License X. The entity allocates $800 to License X in accordance with paragraph 606-10-32-41. This is because, based on an assessment of the facts and circumstances relating to both licenses, allocating to License Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 606-10-32-28.

606-10-55-273

The entity transfers License Y at inception of the contract and transfers License X one month later. Upon the transfer of License Y, the entity does not recognize revenue because the consideration allocated to License Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph 606-10-55-65, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

606-10-55-274

When License X is transferred, the entity recognizes as revenue the $800 allocated to License X.

Case B — Variable Consideration Allocated on the Basis of Standalone Selling Prices

606-10-55-275

The price stated in the contract for License X is a fixed amount of $300, and for License Y the consideration is 5 percent of the customer's future sales of products that use License Y. The entity's estimate of the sales-based royalties (that is, the variable consideration) is $1,500 in accordance with paragraph 606-10-32-8.

606-10-55-276

To allocate the transaction price, the entity applies the criteria in paragraph 606-10-32-40 to determine whether to allocate the variable consideration (that is, the sales-based royalties) entirely to License Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y), allocating the variable consideration entirely to License Y would be inconsistent with the principle for allocating the transaction price. Allocating $300 to License X and $1,500 to License Y does not reflect a reasonable allocation of the transaction price on the basis of the standalone selling prices of Licenses X and Y of $800 and $1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 606-10-32-31 through 32-35.

606-10-55-277

The entity allocates the transaction price of $300 to Licenses X and Y on the basis of relative standalone selling prices of $800 and $1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative standalone selling price basis. However, in accordance with paragraph 606-10-55-65, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

606-10-55-278

License Y is transferred to the customer at the inception of the contract, and License X is transferred three months later. When License Y is transferred, the entity recognizes as revenue the $167 ($1,000 ÷ $1,800 × $300) allocated to License Y. When License X is transferred, the entity recognizes as revenue the $133 ($800 ÷ $1,800 × $300) allocated to License X.

606-10-55-279

In the first month, the royalty due from the customer's first month of sales is $200. Consequently, in accordance with paragraph 606-10-55-65, the entity recognizes as revenue the $111 ($1,000 ÷ $1,800 × $200) allocated to License Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the $89 ($800 ÷ $1,800 × $200) allocated to License X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

6.4 Allocating a discount

The second exception to the relative standalone selling price allocation (see Section 6.3 for the first exception) relates to discounts inherent in contracts. When an entity sells a bundle of goods and services, the selling price of the bundle is often less than the sum of the standalone selling prices of the individual components. Under the relative standalone selling price method, this discount would be allocated proportionately to all of the separate performance obligations.

However, the new standard says that if an entity determines that a discount in an arrangement is not related to all of the promised goods or services in the arrangement, the entity should allocate the discount to only those goods or services to which it relates. An entity would make this determination when the price of certain goods or services is largely independent of other goods or services in the contract. In these situations, an entity would be able to effectively "carve off" an individual performance obligation, or some of the performance obligations in the arrangement, and allocate the discount to that performance obligation or group of obligations.

The standard states the following:

The allocation of discounts to a single performance obligation under the new standard represents a significant change from current practice.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

Allocation of a Discount

606-10-32-37

An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.

b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.

c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

While the standard contemplates that an entity can allocate a discount to as few as one performance obligation, the Boards clarified in the Basis for Conclusions that they believe such a situation would be rare. Instead, the Boards believe it is more likely that an entity will be able to demonstrate that a discount relates to two or more performance obligations because it would likely have observable information supporting that the standalone selling price of a group of promised goods or services is lower than the pricing of those items when sold separately. It likely would be more difficult for an entity to have sufficient evidence to demonstrate that a discount is associated with a single performance obligation.

The standard includes the following example to illustrate this concept:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 34 — Allocating a Discount

606-10-55-259

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

606-10-55-260

In addition, the entity regularly sells Products B and C together for $60.

Case A — Allocating a Discount to One or More Performance Obligations

606-10-55-261

The entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time.

606-10-55-262

The contract includes a discount of $40 on the overall transaction, which would be allocated proportionately to all 3 performance obligations when allocating the transaction price using the relative standalone selling price method (in accordance with paragraph 606-10-32-36). However, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37.

606-10-55-263

If the entity transfers control of Products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate $60 of the transaction price to the single performance obligation and recognize revenue of $60 when Products B and C simultaneously transfer to the customer.

606-10-55-264

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 x $60)
Product C	27	($45 ÷ $100 total standalone selling price x $60)
Total	$ 60	

Case B — Residual Approach Is Appropriate

606-10-55-265

The entity enters into a contract with a customer to sell Products A, B, and C as described in Case A. The contract also includes a promise to transfer Product D. Total consideration in the contract is $130. The standalone selling price for Product D is highly variable (see paragraph 606-10-32-34(c)(1)) because the entity sells Product D to different customers for a broad range of amounts ($15 — $45). Consequently, the entity decides to estimate the standalone selling price of Product D using the residual approach.

606-10-55-266

Before estimating the standalone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 606-10-32-37 through 32-38.

606-10-55-267

As in Case A, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has observable evidence that $100 should be allocated to those 3 products and a $40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37. Using the residual approach, the entity estimates the standalone selling price of Product D to be $30 as follows:

Product	**Standalone selling price**	**Method**
Product A	$ 40	Directly observable (see paragraph 606-10-32-32)
Product B and C	60	Directly observable with discount (see paragraphs 606-10-32-37)
Product D	30	Residual approach (see paragraph 606-10-32-34(c))
Total	$ 130	

606-10-55-268

The entity observes that the resulting $30 allocated to Product D is within the range of its observable selling prices ($15 — $45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 606-10-32-28 and the guidance in paragraph 606-10-32-33.

Case C — Residual Approach Is Inappropriate

606-10-55-269

The same facts as in Case B apply to Case C except the transaction price is $105 instead of $130. Consequently, the application of the residual approach would result in a standalone selling price of $5 for Product D ($105 transaction price less $100 allocated to Products A, B, and C). The entity concludes that $5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D because $5 does not approximate the standalone selling price of Product D, which ranges from $15 — $45. Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the standalone selling price of Product D using another suitable method. The entity allocates the transaction price of $130 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.

As illustrated by this example, the exception also allows only a portion of the total discount within an arrangement to be allocated directly to a bundle of some, but not all, of the elements within the arrangement. That is, in Scenario B outlined above, some of the discount inherent in the arrangement is allocated to Products B and C based on the discounted price at which that bundle is regularly sold, and any remaining discount in the arrangement is allocated to Product D based on the residual approach.

The ability to allocate a discount in a multiple-element arrangement to certain, but not all, performance obligations within the arrangement is a significant change from current practice. Under today's guidance, discounts inherent in arrangements generally are allocated across all deliverables proportionately or allocated only to the first-delivered items. While this exception will likely be helpful in certain circumstances, the criteria that must be met to demonstrate that a discount should be associated with only some of the performance obligations in the arrangement likely will limit the number of transactions that will be eligible for this exception.

6.5 Changes in transaction price after contract inception

Changes in the total transaction price are allocated to the separate performance obligations on the same basis as the initial allocation, whether they are allocated based on the relative standalone selling price (i.e., using the same proportionate share of the total) or to individual performance obligations as discussed above. As discussed in Section 6.1 above, standalone selling prices are not updated after contract inception.

However, if the contract is modified, the contract modification guidance in ASC 606-10-25-10 through 25-13 must be followed. See Section 3.3 for a discussion of contract modifications. Changes in transaction price resulting from the modification would also be subject to that guidance.

However, when arrangements include variable consideration, it is possible that changes in the transaction price can arise after the modification, and such changes may or may not be related to performance obligations that existed before the modification. For changes in the transaction price arising after a contract modification, for which the contract modification was not treated as a separate contract, an entity must apply one of the following approaches:

- If the change in transaction price is attributable to an amount of variable consideration promised before the modification and the modification was considered a termination of the existing contract and the creation of a new contract, the entity allocates the change in transaction price to the performance obligations that existed before the modification.
- In all other cases, the change in the transaction price should be allocated to the performance obligations in the modified contract (i.e., the performance obligations that were unsatisfied and partially unsatisfied immediately after the modification).

6.6 Allocation of transaction price to elements outside the scope of the standard

Revenue arrangements frequently contain multiple elements, including some elements that are not in the scope of the revenue literature. As discussed further in Section 2.3, the new standard indicates that in such situations, an entity must first apply the other guidance if that guidance addresses separation and/or measurement.

For example, guidance exists that requires certain items, such as derivatives, to be accounted for at fair value. As a result, when a revenue arrangement includes that type of element, the fair value of that element must be separated from the total transaction price, and the remaining transaction price should be allocated to the remaining performance obligations.

The following example illustrates this concept:

Illustration 6-3: Arrangements with elements that must be accounted for at fair value

Company A, an oil producer, agrees to sell 1,200 barrels of crude oil to Company B and immediately delivers it. As part of the agreement, Company A also writes an option for Company B to purchase an additional 1,000 barrels of crude oil in six months. The option does not qualify for the normal purchases and sales exception in the derivatives and hedging guidance in ASC 815[20] and is accounted for as a derivative. The crude oil and the option can be accounted for separately pursuant to the revenue guidance.

The total transaction price is $50,000. The standalone selling price of the delivered crude oil and the fair value of the option are $48,000 and $7,000, respectively.

Analysis

Because ASC 815 requires that derivatives be recorded at fair value and remeasured at fair value in subsequent periods, an amount of the transaction price equal to the option's fair value should be allocated to it. The allocation of the total transaction price is as follows:

	Selling price and fair value	% Allocated discount	Allocated discount	Arrangement consideration allocation
Crude oil	$ 48,000	100%	$ 5,000	$ 43,000
Option	7,000	0%	–	7,000
	$ 55,000		$ 5,000	$ 50,000

For elements that must be accounted for at fair value at inception, any remeasurement (i.e., the "day two" accounting) should be pursuant to other GAAP (e.g., ASC 815). That is, subsequent adjustments to the fair value of those elements have no effect on the amount of the transaction price previously allocated to any performance obligations included in the arrangement or on revenue recognized.

7 Satisfaction of performance obligations

Under the standard, an entity recognizes revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Recognizing revenue upon a transfer of control is a different approach from the "risks and rewards" model that currently exists in today's guidance. The standard states that "control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset." Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

Under the new standard, the transfer of control to the customer represents the transfer of the rights with regard to the good or service. The customer's ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services. Upon transfer of control, the customer has sole possession of the right to use the good or service for the remainder of its economic life or to consume the good or service in its own operations.

The standard indicates that an entity must determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. These concepts are explored further in the following sections.

7.1 Performance obligations satisfied over time

Frequently, entities transfer the promised goods and services to the customer over time. While the determination of whether goods or services are transferred over time is straightforward in some arrangements (e.g., many service contracts), this determination is more difficult in other arrangements. To help entities determine whether control transfers over time (rather than at a point in time), the Boards provided the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied Over Time

606-10-25-27

An entity transfers control of a good or service over time and, therefore, satisfies a **performance obligation** and recognizes **revenue** over time, if one of the following criteria is met:

a. The **customer** simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).

b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).

c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

Examples of each of the above criteria are included in the following sections. If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time (see Section 7.2).

7.1.1 *Customer simultaneously receives and consumes benefits as the entity performs*

The standard states the following related to the first criterion, which is the simultaneous receipt and consumption of the benefits of the entity's performance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Simultaneous Receipt and Consumption of the Benefits of the Entity's Performance (paragraph 606-10-25-27(a))

606-10-55-5

For some types of **performance obligations**, the assessment of whether a **customer** receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

606-10-55-6

For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer. In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity should make both of the following assumptions:

a. Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity

b. Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

As discussed in the Basis for Conclusions, the Boards created this criterion to clarify that in "pure" service contracts, entities generally transfer services over time. In addition, they meant for this criterion to apply only to services, not to goods. As a result, the Boards note that an entity does not apply this guidance to determine whether a performance obligation is satisfied over time if the entity's performance creates an asset the customer does not consume completely as the asset is received. Instead, an entity assesses that performance obligation using the criteria discussed in Sections 7.1.2 and 7.1.3.

For some service arrangements, the entity's performance may not result in the recognition of an asset as the entity performs, but the customer also is not consuming the benefit of the entity's performance until the entity's performance is complete. The standard provides an example of an entity providing consulting services that will take the form of a professional opinion upon the completion of the services. In this situation, an entity cannot conclude that the services are transferred over time based on this criterion. Instead, it must consider the remaining two criteria (see Section 7.1.3).

The standard provides the following example showing a customer simultaneously receiving and consuming the benefits as the entity performs:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 13 — Customer Simultaneously Receives and Consumes the Benefits

606-10-55-159

An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

606-10-55-160

The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 606-10-25-14(b). The performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to reperform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

7.1.2 *Customer controls asset as it is created or enhanced*

The second criterion to determine that control of a good or service is transferred over time is that the customer controls the asset as it is being created or enhanced. For purposes of this determination, the definition of "control" is the same as previously discussed (i.e., the ability to direct the use of and obtain substantially all of the remaining benefits from the asset). Further, the asset being created or enhanced can be either tangible or intangible. For example, in a contract to develop an IT system on the customer's premises, the customer controls the system while it is being developed or enhanced, and therefore, control is transferred over time. Many construction contracts with the US federal government also contain clauses indicating that the government owns any work-in-progress as the contracted item is being built. The Boards believe the customer's control over the asset as it is being created or enhanced indicates that the entity's performance transfers goods or services to a customer over time.

7.1.3 *Asset with no alternative use and right to payment*

The last criterion to determine that control is transferred over time has the following two requirements:

- The entity's performance does not create an asset with alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

Each of these concepts is discussed further below.

Alternative use

The standard includes the following guidance on "alternative use:"

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied Over Time

606-10-25-28

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state to another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the **contract** approve a contract modification that substantively changes the performance obligation. Paragraphs 606-10-55-8 through 55-10 provide guidance for assessing whether an asset has an alternative use to the entity.

Implementation Guidance and Illustrations

Entity's Performance Does Not Create an Asset with an Alternative Use (paragraph 606-10-25-27(c))

606-10-55-8

In assessing whether an asset has an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different **customer**. The possibility of the **contract** with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

606-10-55-9

A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

606-10-55-10

A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

The Boards concluded that when an entity is creating something that is highly customized for a particular customer, it is less likely that the entity could use that asset for any other purpose. That is, the entity would likely need to incur significant rework costs or sell the asset at a significantly reduced price. As a result, the customer could be regarded as having control of the goods or services. However, in this situation, the Boards concluded it was not enough to determine that the customer controls the asset. The entity would also need to determine it has an enforceable right to payment for performance to date, as discussed below.

In making the assessment of whether a good or service has alternative use, an entity must consider any substantive contractual restrictions. A contractual restriction is substantive if an entity expects the customer to enforce its rights to the promised asset if the entity sought to direct the asset for another use. Contractual restrictions that are not substantive should not be considered. It is important to note that the standard also includes a practical limitation, and therefore, an asset would not have an alternative use if the entity would incur significant economic losses to direct the asset for another use. After contract inception, an entity does not update its assessment of whether an asset has an alternative use for any subsequent changes in facts and circumstances, unless the parties approve a contract modification.

How we see it

The assessment at contract inception of whether a good or service has an alternative use will require significant judgment and consideration of all the facts and circumstances of the contract. One important factor to be considered is the effects of substantive contractual restrictions and practical limitations on an entity's ability to readily direct that asset for another use, such as selling it to a different customer.

Enforceable right to payment for performance completed to date

When evaluating whether an entity has an enforceable right to payment for performance completed to date, the standard requires that the entity consider the terms of the contract and any laws or regulations that relate to it. The standard states that the right to payment for performance completed to date need not be for a fixed amount. However, at any time during the contract term, an entity must be entitled to an amount that at least compensates the entity for performance completed to date, even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised. The Boards concluded that a customer's obligation to pay for the entity's performance is an indicator that the customer has obtained benefit from the entity's performance.

The standard says the following about an entity's right to payment for performance completed to date:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Right to Payment for Performance Completed to Date (paragraph 606-10-25-27(c))

606-10-55-11

In accordance with paragraph 606-10-25-29, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the **customer** or another party terminates the **contract** for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the **performance obligation** plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)

b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

606-10-55-12

An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

606-10-55-13

In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contact without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

Entities are required to consider any laws, legislation or legal precedent that could supplement or override the contractual terms. In addition, the standard clarifies that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. The entity must examine information that may contradict the payment schedule and may represent the entity's actual right to payment for performance completed to date. As highlighted in the following illustration, payments from a customer must approximate the selling price of the goods or services transferred to date to be considered a right to payment for performance to date. A fixed payment schedule may not meet this requirement.

The standard provides the following example to illustrate the concepts described here in Section 7.1.3:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 14 — Assessing Alternative Use and Right to Payment

606-10-55-161

An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 percent margin. The 15 percent margin approximates the profit margin that the entity earns from similar contracts.

606-10-55-162

The entity considers the criterion in paragraph 606-10-25-27(a) and the guidance in paragraphs 606-10-55-5 through 55-6 to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially reperform the work that the entity had completed to date because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 606-10-25-27(a) is not met.

606-10-55-163

However, the entity's performance obligation meets the criterion in paragraph 606-10-25-27(c) and is a performance obligation satisfied over time because of both of the following factors:

a. In accordance with paragraphs 606-10-25-28 and 606-10-55-8 through 55-10, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.

b. In accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

606-10-55-164

Consequently, the entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

7.1.4 *Measuring progress*

When an entity has determined that a performance obligation is satisfied over time, the standard requires the entity to select a single revenue recognition method for the relevant performance obligation that best depicts the entity's performance in transferring the goods or services. The standard provides the following guidance to meet this objective:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Measuring Progress toward Complete Satisfaction of a Performance Obligation

606-10-25-31

For each **performance obligation** satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity shall recognize **revenue** over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a **customer** (that is, the satisfaction of an entity's performance obligation).

606-10-25-32

An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

Methods for Measuring Progress

606-10-25-33

Appropriate methods of measuring progress include output methods and input methods. Paragraphs 606-10-55-16 through 55-21 provide guidance for using output methods and input methods to measure an entity's progress toward complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

606-10-25-34

When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

606-10-25-35

As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

While the standard requires an entity to continuously update its estimates related to the measure of progress selected, it does not allow a change in methods. That is, a performance obligation is accounted for under the method the entity selects (i.e., either the input or output method) until it has been fully satisfied. It would not be appropriate for an entity to start recognizing revenue based on an input measure, and then switch to an output measure.

The standard provides two types of methods for recognizing revenue on arrangements involving the transfer of goods and services over time: (1) an input method and (2) an output method. The standard says the following about those methods:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Output Methods

606-10-55-17

Output methods recognize **revenue** on the basis of direct measurements of the value to the **customer** of the goods or services transferred to date relative to the remaining goods or services promised under the **contract**. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity should consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the **performance obligation**. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

606-10-55-18

As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

606-10-55-19

The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.

Input Methods

606-10-55-20

Input methods recognize **revenue** on the basis of the entity's efforts or inputs to the satisfaction of a **performance obligation** (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

606-10-55-21

A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a **customer**. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).

b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

    1. The good is not distinct.

    2. The customer is expected to obtain control of the good significantly before receiving services related to the good.

    3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.

    4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

While the standard does not establish preferability, it does say that the selected method should be applied to similar arrangements in similar circumstances. Regardless of which method an entity selects, it excludes from its measure of progress any goods or services for which control has not transferred.

In determining the best method of measuring progress, an entity has to consider both the nature of the promised goods or services and the nature of the entity's performance. To illustrate this concept, the Basis for Conclusions cites an arrangement for health club services. Regardless of when or how frequently the customer uses the health club, the entity's obligation to stand ready for the contracted period of time does not change.

The standard does not list passage of time as a separate method of measuring progress. However, the Boards specifically included "time elapsed" as examples of an input or output measure that an entity may use.

The Boards provided a practical expedient for an entity that has a right to payment from a customer in an amount that corresponds directly with the value of the entity's performance completed to date (e.g., a service contract in which an entity bills a fixed amount for each hour of service provided). The practical expedient allows an entity to recognize revenue in the amount for which it has the right to invoice.

If an entity does not have a reasonable basis to measure its progress, the Boards decided that too much uncertainty exists, and therefore, revenue should not be recognized until progress can be measured. An entity may be able to determine that a loss will not be incurred but is unable to reasonably estimate the amount of profit. Until it is able to reasonably measure the outcome, the standard requires the entity to recognize revenue but only up to the amount of the costs incurred.

Illustration 7-1: Choosing the measure of progress

A shipbuilding entity enters into an arrangement to build 15 vessels for a customer over a three-year period. The customer played a significant role in the design of the vessels, and the entity has not built a vessel of this nature in the past. As a result, the arrangement includes both design and production services. In addition, the entity expects that the first vessels may take longer to produce than the last vessels because, as the entity gains experience building the vessels, it expects to be able to construct them more efficiently.

Assume that the entity has determined that the design and production services represent a single performance obligation. In such situations, the entity would likely not choose a "units of delivery" method as a measure of progress because that method would not capture accurately the level of performance. That is, such a method wouldn't reflect the entity's efforts during the design phase of the arrangement because no revenue would be recognized until a vessel was shipped. In such situations, an entity would likely determine that an input method, such as a percentage of completion method based on costs incurred approach, is more appropriate.

The Boards concluded in the Basis for Conclusions that a units-of-delivery or units-of-production method may not be appropriate if the contract provides both design and production services because each item produced may not transfer an equal amount of value to the customer. That is, the items produced earlier likely have a higher value than the ones produced later. However, the Boards indicated that units of delivery may be an appropriate approach for certain long-term manufacturing contracts of standard items that individually transfer an equal amount of value to the customer.

7.1.5 Adjustments to the measure of progress when based on an input method

If an entity applies an input method that uses costs incurred to measure its progress toward completion (e.g., cost to cost), the cost incurred may not always be proportionate to the entity's progress in satisfying the performance obligation. For example, in a performance obligation composed of goods and services, the customer may obtain control of the goods before the entity provides the services related to those goods (e.g., goods are delivered to a customer site but the entity has not yet integrated the goods into the overall project). The Boards concluded that using a measure of progress based on costs incurred for such a transaction may be inappropriately affected by the delivery of these goods and that a pure application of such a measure of progress would result in overstated revenue.

The standard indicates that in such circumstances there may be a better way to measure progress toward completion of a performance obligation. The standard provides an example of recognizing revenue at an amount equal to the cost of the goods used (rather than cost incurred on the contract) because the cost incurred is not proportionate to an entity's progress in satisfying a performance obligation. The standard specifies that in order to recognize revenue in these situations, the conditions in ASC 606-10-55-21(b) (excerpted above) must be met.

In addition, situations may arise in which all of the costs incurred do not contribute to the entity's progress in completing the performance obligation. Under an input method, an entity should exclude these types of costs (e.g., costs related to significant inefficiencies, wasted materials, required re-work) from the measure of progress unless such costs were reflected in the price of the contract.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 19 — Uninstalled Materials

606-10-55-187

In November 20X2, an entity contracts with a customer to refurbish a 3-story building and install new elevators for total consideration of $5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are $4 million, including $1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs 606-10-55-36 through 55-40 because it obtains control of the elevators before they are transferred to the customer.

606-10-55-188

A summary of the transaction price and expected costs is as follows:

Transaction price	$ 5,000,000
Cost of elevators	1,500,000
Other costs	2,500,000
Total expected costs	$ 4,000,000

606-10-55-189

The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation in accordance with paragraph 606-10-55-21. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators ($1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation ($4 million). The entity is not involved in designing or manufacturing the elevators.

606-10-55-190

The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph 606-10-55-21, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

606-10-55-191

As of December 31, 20X2, the entity observes that:

a. Other costs incurred (excluding elevators) are $500,000.

b. Performance is 20% complete (that is, $500,000 ÷ $2,500,000).

606-10-55-192

Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	$ 2,200,000[(a)]
Cost of goods sold	2,000,000[(b)]
Profit	$ 200,000

(a) Revenue recognized is calculated as (20% x $3,500,000) + $1,500,000. ($3,500,000 million is $5,000,000 transaction price − $1,500,000 cost of elevator).

(b) Cost of goods sold is $500,000 of costs incurred + 1,500,000 costs of elevators

While the new standard does not dictate which approach an entity should use in these situations, an entity should not use an input method based on costs incurred to measure progress when costs are disproportionate to the entity's progress throughout the life of the contract. Not using a percentage of completion method in which costs incurred are used to measure the stage of completion may represent a significant change for some entities.

7.2 Control transferred at a point in time

For performance obligations for which control is not transferred over time, control is transferred at a point in time. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in other circumstances, this determination is more complex.

To help entities determine the point in time when a customer obtains control of a particular good or service, the Boards provided the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Recognition

Performance Obligations Satisfied at a Point in Time

606-10-25-30

If a **performance obligation** is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a **customer** obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on

control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset — If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

b. The customer has legal title to the asset — Legal title may indicate which party to a **contract** has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

c. The entity has transferred physical possession of the asset — The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

d. The customer has the significant risks and rewards of ownership of the asset — The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

e. The customer has accepted the asset — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

None of the indicators above are meant to individually determine whether the customer has gained control of the good or service. An entity must consider all relevant facts and circumstances to determine whether control has transferred. The Boards also clarified that the indicators are not meant to be a checklist, and not all of them must be present for an entity to determine that the customer has gained control. Rather, the indicators are factors that are often present when a customer has obtained control of an asset, and the list is meant to help entities apply the principle of control.

The standard includes the following example to illustrate revenue recognition over time (see Section 7.1) and at a point in time (see Section 7.2).

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 17 — Assessing Whether a Performance Obligation Is Satisfied at a Point in Time or Over Time

606-10-55-173

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A—Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date

606-10-55-174

The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

606-10-55-175

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 606-10-25-27(c). Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Case B—Entity Has an Enforceable Right to Payment for Performance Completed to Date

606-10-55-176

The customer pays a nonrefundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

606-10-55-177

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

606-10-55-178

The entity also has a right to payment for performance completed to date in accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

606-10-55-179

Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 606-10-25-27(c) are met, and the entity has a performance obligation that it satisfies over time. To recognize revenue for that performance obligation satisfied over time, the entity measures its progress toward complete satisfaction of its performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

606-10-55-180

In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract.

Case C—Entity Has an Enforceable Right to Payment for Performance Completed to Date

606-10-55-181

The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

606-10-55-182

Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph 606-10-55-13), provided that the entity's rights to require the customer to continue to perform as required under the contract (that is, pay the promised consideration) are enforceable.

7.3 Repurchase agreements

Some agreements include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods.

The standard clarifies the types of arrangements that qualify as repurchase agreements:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Repurchase Agreements

606-10-55-66

A repurchase agreement is a **contract** in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the **customer**, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

606-10-55-67

Repurchase agreements generally come in three forms:

a. An entity's obligation to repurchase the asset (a forward)

b. An entity's right to repurchase the asset (a call option)

c. An entity's obligation to repurchase the asset at the customer's request (a put option).

7.3.1 Forward or call option held by the entity

When an entity has the unconditional obligation or right to repurchase an asset, the standard indicates that the customer has not obtained control of the asset. Instead, the standard provides the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

A Forward or a Call Option

606-10-55-68

If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a **customer** does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the **contract** as either of the following:

a. A lease in accordance with Topic 840 on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 840-40.

b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

The guidance above requires that an entity account for a transaction, including a forward or a call option, based on the relationship between the repurchase price and the original selling price. The standard indicates that if the entity has the right or obligation to repurchase the asset at a price less than the original sales price (taking into consideration the effects of the time value of money), the entity would account for the transaction as a lease in accordance with ASC 840, unless the contract is part of a sale-leaseback transaction. If the entity has the right or obligation to repurchase the asset at a price equal to or greater than the original sales price (considering the effects of the time value of money), the entity would account for the arrangement as a financing arrangement.

The standard does not differ significantly from today's guidance in ASC 470-40[21] for many transactions. However, entities that retain an option to repurchase a good from the customer as a part of sales contracts may see a change in practice. Under the new standard, *any* transaction with a seller option to repurchase the product must be treated as a financing arrangement or a lease (i.e., not a sale) because the customer does not have control of the product and is constrained in its ability to direct the product's use. Under today's guidance, not all seller options to repurchase products trigger the requirement to account for the arrangement as a financing arrangement.

If a transaction is considered a financing arrangement under the new standard, the selling entity will continue to recognize the asset and record a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration subsequently paid to the customer (upon repurchasing the asset) will represent the interest and holding costs, as applicable, that will be recognized over the term of the financing arrangement. If the option lapses unexercised, the entity will derecognize the liability and recognize revenue at that time.

How we see it

Because the standard treats all forwards and call options the same way and does not consider their likelihood of exercise, a significant change in practice may occur for some entities. In certain transactions, an entity may have an unconditional right to repurchase an asset at an amount equal to or greater than the original sales price. For example, some luxury designers have the right to repurchase their handbags at an amount equal to the original sales price. This call option serves as a protective right over the brand's reputation, but the designer is unlikely to exercise the option. The standard nevertheless would require the designer to account for all transactions, including this option, as financing arrangements.

Given that the Boards have embedded lease guidance in the new revenue standard, it will be important for entities not to overlook this guidance.

The standard provides the following example of a call option:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 62 — Repurchase Agreements

606-10-55-401

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

Case A — Call Option: Financing

606-10-55-402

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.

606-10-55-403

Control of the asset does not transfer to the customer on December 31, 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.

606-10-55-404

On December 31, 20X7, the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.

7.3.2 Written put option held by the customer

The new standard indicates that if the customer has the ability to require an entity to repurchase an asset (i.e., a put option) at a price lower than the original selling price, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. That is, this determination influences whether the customer truly has control over the asset received.

The determination of whether an entity has a significant economic incentive to exercise its right will determine whether the arrangement is treated as a lease or a sale with the right of return (discussed in Section 5.2.2). An entity must consider many factors to determine whether a customer has a significant economic incentive to exercise its right, including the relationship of the repurchase price to the expected market value of the asset at the date of repurchase and the amount of time until the right expires. The standard notes that if the repurchase price is expected to significantly exceed the market value of the asset, the customer has a significant economic incentive to exercise the put option.

If a customer has a significant economic incentive to exercise its right and the customer is expected to ultimately return the asset, the entity should account for the agreement as a lease because the customer is effectively paying the entity for the right to use the asset for a period of time. An exception would be if the contract is part of a sale-leaseback, in which case the contract should be accounted for as a financing arrangement.

If a customer does not have a significant economic incentive to exercise its right, the entity should account for the agreement in a manner similar to a sale of a product with a right of return. A repurchase price of an asset that is equal to or greater than the original selling price but less than or equal to the expected market value of the asset should also be accounted for as a sale of a product with a right of return, if the customer does not have a significant economic incentive to exercise its right. See Section 5.2.2 for a discussion of sales with a right of return.

If the customer has the ability to require an entity to repurchase the asset at a price equal to or more than the original selling price and the repurchase price is more than the expected market value of the asset, the contract is in effect a financing arrangement.

The standard provides the following guidance for the accounting of a financing arrangement:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

A Put Option

606-10-55-75

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, should be accounted for as described in paragraph 606-10-55-70.

606-10-55-76

If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

How we see it

The guidance in the new revenue standard on written put options is different from today's guidance because it requires an entity to determine whether the customer has a significant economic incentive to exercise its right. Under today's guidance, when an arrangement includes a written put option that is designed to compensate the customer for holding costs (including interest), the arrangement is accounted for as a financing arrangement, regardless of the likelihood that the customer will exercise that option.

However, the new standard does not provide any guidance on determining whether "a significant economic incentive" exists, and judgment may be required to make this determination.

The standard provides the following example of a put option:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 62 — Repurchase Agreements

606-10-55-401

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

Case B — Put Option: Lease

606-10-55-405

Instead of having a call option, 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.

606-10-55-406

At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs 606-10-55-72 through 55-78). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

606-10-55-407

In accordance with paragraphs 606-10-55-72 through 55-73, the entity accounts for the transaction as a lease in accordance with Topic 840 on leases.

7.3.3 *Sales with residual value guarantees*

An entity that sells equipment may guarantee that the customer will receive a minimum resale amount when the customer resells the equipment. ASC 840-10-55-12 precludes the entity from recognizing a sale on the equipment if it guarantees the resale value and instead requires the arrangement to be accounted for as a lease. The new standard does not change that.

However, an entity may be able to conclude that sale treatment is appropriate if the repurchase agreements guidance in the new standard applies. For example, if the residual value guarantee is accomplished by executing a put within the contract (e.g., the customer has the right to require the entity to repurchase equipment two years after the date of purchase at 85% of the original purchase price), the entity would have to use the new revenue standard to determine whether the existence of the put precludes the customer from obtaining control of the acquired item. In doing so, the entity would determine whether the customer has a significant economic incentive to exercise the put. If the entity concludes that there is no significant economic incentive, the transaction would be accounted for as a sale in accordance with the new standard. Alternatively, if the entity concludes there is a significant economic incentive for the customer to exercise its right, the transaction would be accounted for as a lease as discussed above.

If the transaction includes a residual value guarantee in which the entity will make the customer whole if the customer receives less than 85% of the initial sale price in a qualifying future sale, it is not clear whether the repurchase agreement guidance in the new revenue standard would apply. That is, because the entity is not repurchasing the asset, that guidance may not apply. Instead, the transaction may be viewed as including a component of variable consideration. While the economics of a repurchase agreement and a residual value guarantee may be similar, the accounting outcome could be quite different.

7.4 Bill-and-hold arrangements

In certain sales transactions, the selling entity fulfills its obligations and bills the customer for the work performed but does not ship the goods until a later date. These transactions, often called "bill-and-hold" transactions, usually are designed this way at the request of the customer for a number of reasons, including a lack of storage capacity or its inability to use the goods until a later date.

The criteria for determining whether a bill-and-hold transaction qualifies for revenue recognition under the new standard are similar to, but somewhat less detailed than, today's criteria in SAB Topic 13, as well as (a) Securities Exchange Act Release 23507 and Accounting and Auditing Enforcement Release No. 108 and (b) SEC Release Nos. 33-8642, 34-52885 and IC-27178. For example, the requirements in SAB Topic 13 that the customer requests that the entity retain the completed product and that the arrangement include a fixed delivery schedule are not considerations under the standard. We expect that most bill-and-hold transactions that would qualify for revenue recognition under today's guidance will also qualify for revenue recognition under the standard.

How we see it

Entities that record revenue on bill-and-hold arrangements should stay abreast of developments in this area.

The new standard provides the following guidance and an illustrative example with respect to these arrangements:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Bill-and-Hold Arrangements

606-10-55-81

A bill-and-hold arrangement is a **contract** under which an entity bills a **customer** for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

606-10-55-82

An entity should determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 606-10-25-30). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

606-10-55-83

In addition to applying the guidance in paragraph 606-10-25-30, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

606-10-55-84

If an entity recognizes **revenue** for the sale of a product on a bill-and-hold basis, the entity should consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 606-10-25-14 through 25-22 to which the entity should allocate a portion of the **transaction price** in accordance with paragraphs 606-10-32-28 through 32-41.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 63 — Bill-and-Hold Arrangement

606-10-55-409

An entity enters into a contract with a customer on January 1, 20X8, for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

606-10-55-410

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On December 31, 20X9, the customer pays for the machine and spare parts but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts, and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse, and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years, and the entity does not have the ability to use the spare parts or direct them to another customer.

606-10-55-411

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts, and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognized when (or as) control transfers to the customer.

606-10-55-412

Control of the machine transfers to the customer on December 31, 20X9, when the customer takes physical possession. The entity assesses the indicators in paragraph 606-10-25-30 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts, and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria in paragraph 606-10-55-83 are met, which is necessary for the entity to recognize revenue in a bill-and-hold arrangement. The entity recognizes revenue for the spare parts on December 31, 20X9, when control transfers to the customer.

606-10-55-413

The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity considers whether the payment terms include a significant financing component in accordance with paragraphs 606-10-32-15 through 32-20.

7.5 Customer acceptance

When determining whether the customer has obtained control of the goods or services, an entity must consider any customer acceptance clauses that require the customer to approve the goods or services before it is obligated to pay for them. These clauses may be straightforward, giving a customer the ability to accept or reject the goods or services based on objective criteria specified in the contract (e.g., the goods function at a specified speed), or may be more subjective in nature. If a customer does not accept the goods or services, the seller may not be entitled to consideration, may be required to take remedial action or may be required to take back the delivered good.

The standard provides the following guidance on how customer acceptance provisions should be evaluated:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Customer Acceptance

606-10-55-85

In accordance with paragraph 606-10-25-30(e), a **customer's** acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a **contract** or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity should consider such clauses when evaluating when a customer obtains control of a good or service.

606-10-55-86

If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If **revenue** is recognized before customer acceptance, the entity still must consider whether there are any remaining **performance obligations** (for example, installation of equipment) and evaluate whether to account for them separately.

606-10-55-87

However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because, in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

606-10-55-88

If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

In certain circumstances, the determination of whether the acceptance criteria are subjective and whether they have been met will require professional judgment. However, this is consistent with current practice.

7.6 Licensing and rights to use

The new standard provides a model for determining the timing of transfer of control for licenses of intellectual property that is different from the general guidance. Any licenses of intellectual property that are determined to be distinct must apply this separate guidance. We discuss licensing, rights to use and the satisfaction of those performance obligations in detail in Section 8.4.

7.7 Recognizing revenue when a right of return exists

As discussed in Section 4.7, a right of return does not represent a separate performance obligation. Instead, the existence of a right of return affects the transaction price, and the entity must determine whether the customer will return the transferred product.

Under the standard, an entity estimates the transaction price and recognizes revenue based on the amount to which the entity expects to be entitled through the end of the return period (considering expected product returns). The entity recognizes the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. If the entity is unable to estimate returns, revenue will not be recognized until returns can be reasonably estimated, which may be at the end of the return period. An entity also will update its estimates at each financial reporting date. See Section 5.2.2 for further discussion on this topic.

7.8 Breakage and prepayments for future goods or services

In certain industries, an entity will collect nonrefundable payment from its customers for goods or services that the customer has a right to receive in the future. However, a customer may ultimately leave that right unexercised (often referred to as breakage). For example, retailers frequently sell gift cards that are not completely redeemed, and airlines sometimes sell tickets to passengers who allow the tickets to expire unused. When an entity receives consideration that is attributable to a customer's unexercised rights, the entity should recognize a contract liability equal to the amount prepaid by the customer. Revenue normally would be recognized when the entity satisfies it performance obligation.

Since entities will frequently not be required by customers to fully satisfy their performance obligations, the Boards concluded that when an entity expects to be entitled to a breakage amount, the expected breakage should be recognized as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, breakage amounts would be recognized when the likelihood of the customer exercising its right becomes remote. Because breakage amounts essentially represent a form of variable consideration, in estimating any breakage amount, an entity has to consider the constraint on variable consideration, as discussed in Section 5.1. That is, if it is probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity should not recognize those amounts until the potential for reversal has passed.

It is unclear how the guidance on breakage is meant to interact with the guidance on the determination of a standalone selling price. That is, the guidance on breakage would suggest that an entity should establish a liability for the full amount of the prepayment and recognize breakage on that liability proportionate to the revenue being recognized. This is straightforward in arrangements with only a single element (e.g., a retailer sells a gift card to a customer).

However, if the prepayment element (e.g., the sale of a gift card, frequent flyer miles) is part of a multiple-element arrangement, it is less clear how an entity should account for it. In multiple-element arrangements, the entity must determine the standalone selling price of each element, including the prepaid component. If the standalone selling price for the prepaid component is not directly observable (e.g., the price of frequent flyer miles), the standard

requires an entity to estimate it. In making this estimate, it appears reasonable that an entity would take into consideration the likelihood that the customer ultimately requests the services they have paid for in advance, or the potential breakage, as illustrated by Example 52 included in the revenue standard below.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 52 — Customer Loyalty Program

606-10-55-353

An entity has a customer loyalty program that rewards a customer with 1 customer loyalty point for every $10 of purchases. Each point is redeemable for a $1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for $100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed, and the standalone selling price of the purchased products is $100,000. The entity expects 9,500 points to be redeemed. The entity estimates a standalone selling price of $0.95 per point (totalling $9,500) on the basis of the likelihood of redemption in accordance with paragraph 606-10-55-44.

606-10-55-354

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

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

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

606-10-55-355

At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognizes revenue for the loyalty points of $4,110 [(4,500 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.

606-10-55-356

At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognizes revenue for the loyalty points of $3,493 {[(8,500 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).

Considering the possible lack of redemption when estimating the standalone sales price will result in less revenue being allocated to the prepaid component. As a result, the deferred revenue associated with this component could be less than the contractual "prepayment" amount, which appears inconsistent with the guidance in the standard for these types of transactions.

7.9 Loss contracts

Under today's guidance, some entities are required to recognize losses on onerous contracts for certain arrangements. The new standard indicates that entities with arrangements that were required to accrue expected losses on contracts under today's guidance will continue to be required to do so. Loss contracts are discussed in detail in Section 8.2.

8 Other measurement and recognition topics

8.1 Warranties

Warranties are commonly included in arrangements to sell goods or services, whether explicitly stated or implied based on an entity's customary business practices. The price of such warranties may be included in the overall purchase price or listed separately as an optional product. The new revenue standard identifies two types of warranties:

- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (called "service-type warranties")
- Warranties that promise the customer that the delivered product is as specified in the contract (called "assurance-type warranties")

8.1.1 Service-type warranties

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the 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.

Judgment may be required to determine the appropriate pattern of revenue recognition associated with service-type warranties. For example, an entity may determine that it provides the warranty service continuously over the warranty period (i.e., the performance obligation is an obligation to "stand ready to perform" during the stated warranty period). An entity that makes this determination will likely recognize revenue ratably over the warranty period. An entity also may conclude that a different pattern of recognition is appropriate based on sufficient data about when it provides services. For example, an entity might recognize little or no revenue in the first year of a three-year service-type warranty if historical data indicates that warranty services are typically provided only in the second and third year of the warranty period.

Changes in the estimate of the costs to satisfy service-type warranty performance obligations do not result in a revision to the original relative standalone selling price allocation. For example, an entity may discover two months after a product is shipped that the cost of a part acquired from a third-party manufacturer has tripled and that it will cost the entity significantly more to replace that part if a warranty claim is made. This change will not affect the amount of transaction price that the entity allocated to the service-type warranty because the service-type warranty cost recognition does not affect the revenue recognition.

8.1.2 Assurance-type warranties

The Boards concluded that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a guarantee of quality. Under the standard, these types of warranties are accounted for as warranty obligations, and the estimated cost of satisfying them is accrued in accordance with the current guidance in ASC 460-10 on guarantees. Once recorded, the warranty liability should be assessed on an ongoing basis to ensure that changes in the seller's environment or obligations are reflected in the recorded liability. The liability should be adjusted (with the offset recorded as an adjustment to costs of sales) as changes in estimates occur.

ASC 460-10-25-6 indicates that if the costs of satisfying future warranty obligations cannot be reasonably estimated at the transaction date, a reserve for warranty cannot be accrued, and if the range of possible loss is wide, revenue should not be recognized until a reasonable estimate can be made or the warranty period expires.

8.1.3 Determining whether a warranty is an assurance- or service-type warranty

In certain circumstances, it may be difficult to determine whether a warranty provides a customer with a service in addition to the assurance that the delivered product is as specified in the contract. To help entities make that assessment, the new standard provides the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Warranties

606-10-55-33

In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

a. Whether the warranty is required by law — If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

b. The length of the warranty coverage period — The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

c. The nature of the tasks that the entity promises to perform — If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

How we see it

Entities may need to exercise significant judgment when determining whether a warranty is an assurance-type or service-type warranty. An entity's evaluation may be affected by several factors, including common warranty practices within its industry and the entity's business practices related to warranties. For example, consider an automotive manufacturer that provides a five-year warranty on a luxury vehicle and a three-year warranty on a standard vehicle. The manufacturer may conclude that the longer warranty period is not an additional service because it believes the materials used to construct the luxury vehicle are of a higher quality and latent defects would take longer to appear. In contrast, the manufacturer might compare the warranty with those offered by its competitors and conclude that the five-year warranty period, or some portion of it, is an additional service that should be accounted for as a service-type warranty.

8.1.4 *Arrangements that contain both assurance- and service-type warranties*

Certain arrangements may include both an assurance-type warranty and a service-type warranty, as illustrated below. However, if an entity provides both an assurance-type and service-type warranty within an arrangement and the entity cannot reasonably account for them separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognized over the period the warranty services are provided).

When an assurance-type warranty and a service-type warranty can be accounted for separately, an entity is required to accrue for the expected costs associated with the assurance-type warranty and defer the revenue for the service-type warranty. The following illustration highlights this point.

Illustration 8-1: Service-type and assurance-type warranty

An entity manufactures and sells computers that include an assurance-type warranty for the first 90 days. The entity offers an optional "extended coverage" plan under which it will repair or replace any defective part for three years from the expiration of the assurance-type warranty. Because the optional "extended coverage" plan is sold separately, the entity determines that the three years of extended coverage represent a separate performance obligation (i.e., a service-type warranty).

The total transaction price for the sale of a computer and the extended warranty is $3,600. The entity determines the standalone selling price of each is $3,200 and $400, respectively. The inventory value of the computer is $1,440. Further, the entity estimates that, based on its experience, it will incur $200 in costs to repair defects that arise within the 90-day coverage period for the assurance-type warranty. As a result, the entity will record the following entries:

Dr. Cash/receivables	3,600	
Dr. Warranty expense	200	
Cr. Accrued warranty costs (assurance-type warranty)		200
Cr. Contract liability (service-type warranty)		400
Cr. Revenue		3,200
To record revenue and contract liabilities related to warranties.		

Dr. Cost of sales	1,440	
Cr. Inventory		1,440
To relieve inventory and recognize cost of sales.		

The entity derecognizes the accrued warranty liability associated with the assurance-type warranty as actual warranty costs are incurred during the first 90 days after the customer receives the computer. The entity recognizes the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognizes the costs associated with providing the service-type warranty as they are incurred. That is, under this scenario, the entity would need to be able to determine whether repair costs incurred should be applied against the warranty reserve already established or recognized as an expense in the period incurred.

Accounting for assurance-type warranties and service-type warranties simultaneously may be complex. Entities may need to develop processes to match individual warranty claims with the specific warranty plans so claims can be analyzed for appropriate accounting treatment. This individual assessment of warranty claims is necessary because the assurance-warranty-related costs will have been accrued previously, while the service-type warranty costs are a period expense. See Illustration 8-2 below for an example of this point.

Illustration 8-2: Service-type and assurance-type warranty costs

Assume the same facts as in Illustration 8-1, but assume the entity sold 500 computers during the year. In January of the following year, $10,000 of warranty claims are submitted by customers. The entity analyzes each claim and identifies the specific computer sale to which the claim is related, which it needs to do in order to determine eligibility and the appropriate accounting treatment under the warranty plans.

The entity determines that a portion of the claims, totaling $2,500 for repair and replacement parts, are covered by the assurance-type warranty plan. As shown above in Illustration 8-1, the expected cost of each assurance-type warranty was accrued at the time of the sale. The entity records the following entry to relieve a portion of the warranty liability:

Dr. Accrued warranty costs (assurance-type warranty)	2,500	
Cr. Cash		2,500

To derecognize the assurance-type warranty liability as the costs are incurred.

The entity also determines that a portion of the claims, totaling $7,000 for repair and replacement parts, are eligible under the "extended coverage" plan (i.e., the service-type warranty). The entity records the following entry to recognize the costs associated with the service-type warranty:

Dr. Warranty expense	7,000	
Cr. Cash		7,000

To record the costs of the service-type warranty as the costs are incurred.

The entity also determines that $500 of the claims are not eligible under either warranty plan because the claims relate to incidents that occurred after the 90-day coverage period for the assurance-type warranties and to sales for which the customer did not purchase the extended warranty coverage (i.e., the service-type warranty). The entity rejects these customer claims.

The guidance for assurance-type warranties is essentially the same as current practice. The guidance for service-type warranties is similar to today's accounting under US GAAP, except for the amount of transaction consideration that is allocated to the warranty performance obligation. Currently, entities that provide separately priced extended warranties defer an amount equal to the stated price of the warranty and record that amount as revenue over the warranty period. The new standard requires an entity to defer an allocated amount, based on a relative standalone selling price allocation, which in most cases, will increase judgment and complexity.

8.2 Loss contracts

During the development of the standard, the Boards had proposed requiring entities to accrue for situations in which they expected to incur a loss, either on a single performance obligation (called an onerous performance obligation) or on an entire contract (called an onerous contract). In response to negative feedback received during deliberations, the Boards decided not to include these requirements in the final guidance.

Instead, the Boards elected to retain existing guidance for these situations. As a result, the accounting treatment in this area is not converged, as the current guidance on this topic is not consistent between US GAAP and IFRS.

Under IFRS, the accounting for onerous contracts under International Accounting Standard (IAS) 37, *Provisions, Contingent Liabilities and Contingent Assets*, applies to all contracts in the scope of the revenue standard and requires entities to recognize and measure liabilities for onerous contracts. The liability amount is the lower of the cost to exit (i.e., any compensation or penalties arising from failure to fulfill the contract) or to fulfill the remaining obligations under a contract.

Today, while guidance exists for some industries or for certain types of transactions, general authoritative guidance does not exist for when to recognize losses on onerous contracts and, if a loss is to be recognized, how to measure the loss. Accordingly, diversity in practice exists when such contracts are not within the scope of specific authoritative literature. Because the Boards elected to retain existing guidance for loss contracts, this diversity in practice will likely continue.

Current authoritative literature within US GAAP that requires accrual of expected losses on contracts includes the following:

- A firm purchase commitment for goods or inventory subject to ASC 440-10-25-4[22]
- Contracts within the scope of ASC 605-35
- An operating lease that is subleased subject to ASC 840 or ASC 420
- Certain other executory contracts subject to ASC 420
- An insurance contract with a premium deficiency subject to ASC 944
- Certain derivative contracts within the scope of ASC 815
- Losses on arrangements accounted for pursuant to ASC 985-605

The new guidance states that entities that are required to accrue expected losses on contracts under today's guidance will continue to be required to do so. For example, entities that fall within the scope of the current accounting guidance in ASC 605-35 and are required to account for expected losses on contracts would likely continue to follow that guidance after the new revenue standard takes effect (assuming they continue to meet the revised scope criteria for ASC 605-35, as amended by ASC 606).

8.3 Contract costs

Along with the guidance in ASC 606, ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*, was added to codify the guidance on other assets and deferred costs relating to contracts with customers. This guidance specifies the accounting for costs an entity incurs in obtaining and fulfilling a contract to provide goods and services to customers for both contracts obtained and contracts under negotiation.

8.3.1 Costs to obtain a contract

Under ASC 340-40, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) will be recognized as an asset if the entity expects to recover them. This can mean direct recovery (i.e., through reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits an entity to immediately expense contract

acquisition costs when the asset that would have resulted from capitalizing such costs would have been amortized in one year or less. While not explicitly stated in the standard, we believe entities are permitted to choose this approach as an accounting policy election, and if they do, they must apply it consistently to all short-term acquisition costs.

The standard cites sales commissions as an example of an incremental cost that may require capitalization under the standard. For example, sales commissions that are directly related to sales achieved during a time period would likely represent incremental costs that would require capitalization. In contrast, some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not directly related to obtaining a contract. Another example of an incremental cost may be a legal contingency cost if a lawyer agrees to receive payment only upon the successful completion of a negotiation. Determining which costs must be capitalized under the standard may require judgment.

ASC 340-40 provides the following example regarding incremental costs of obtaining a contract:

Excerpt from the Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 36—Incremental Costs of Obtaining a Contract

606-10-55-281

For an illustration of the incremental costs of obtaining a contract, see Example 1 in Subtopic 340-40 on other assets and deferred costs — costs related to a contract with a customer (paragraphs 340-40-55-2 through 55-4).

Other Assets and Deferred Costs — Contracts with Customers

Implementation and Guidance Illustrations

Example 1 — Incremental Costs of Obtaining a Contract

340-40-55-2

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

340-40-55-3

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.

340-40-55-4

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.

How we see it

The new guidance will represent a significant change for entities that historically have expensed the costs of obtaining a contract and now will be required to capitalize them. In addition, this may be a significant change for entities that currently capitalize costs to obtain a contract by analogizing to the guidance in ASC 310-20[23] (e.g., salaries and benefits for salespeople). Those amounts are not incremental and, therefore, would not be eligible for capitalization under the new standard.

8.3.2 Costs to fulfill a contract

ASC 340-40 divides contract fulfillment costs into two categories: (1) those that give rise to an asset and (2) those that are expensed as incurred. When determining the appropriate accounting treatment for these costs, the guidance states that any other applicable literature should be considered first.

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Recognition

Costs to Fulfill a Contract

340-40-25-5

An entity shall recognize an asset from the costs incurred to fulfill a contract **only if those costs meet all of the following criteria:**

a. **The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).**

b. **The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy)** performance obligations **in the future.**

c. **The costs are expected to be recovered.**

340-40-25-6

For costs incurred in fulfilling a contract with a **customer** that are within the scope of another Topic (for example, Topic 330 on inventory; paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements; Subtopic 350-40 on internal-use software; Topic 360 on property, plant, and equipment; or Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed), an entity shall account for those costs in accordance with those other Topics or Subtopics.

The standard says that costs can be capitalized even if the related revenue contract with the customer is not finalized. However, rather than allowing costs to be related to any potential future contract, the standard requires that the costs be associated with a specifically identifiable anticipated contract.

The standard discusses and provides examples of costs that may meet the first criterion for capitalization listed above (i.e., costs that relate directly to the contract) as follows:

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Recognition

Costs to Fulfill a Contract

340-40-25-7

Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)

b. Direct materials (for example, supplies used in providing the promised services to a customer)

c. Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)

d. Costs that are explicitly chargeable to the customer under the contract

e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

When determining whether costs meet the criteria for capitalization, an entity must consider its specific facts and circumstances. An example of costs incurred that generate or enhance resources of the entity that will be used in satisfying performance obligations in the future may be the intangible design and engineering costs related to future performance that provide (or continue to provide) benefit over the term of the contract.

For costs to meet the "expected to be recovered" criterion, the costs need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin.

Excerpt from the Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 37—Costs That Give Rise to an Asset

606-10-55-282

For an illustration of costs that give rise to an asset, see Example 2 in Subtopic 340-40 on other assets and deferred costs—costs related to a contract with a customer (paragraphs 340-40-55-5 through 55-9).

Other Assets and Deferred Costs — Contracts with Customers

Implementation Guidance and Illustrations

Example 2 — Costs that Give Rise to an Asset

340-40-55-5

An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a $10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

Incremental Costs of Obtaining a Contract

340-40-55-6

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

340-40-55-7

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

340-40-55-8

The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

a. Hardware costs — accounted for in accordance with Topic 360 on property, plant, and equipment

b. Software costs — accounted for in accordance with Subtopic 350-40 on internal-use software

c. Costs of the design, migration, and testing of the data center — assessed in accordance with paragraph 340-40-25-5 to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.

340-40-55-9

In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 340-40-25-5(b)). Therefore, the costs do not meet the criteria in paragraph 340-40-25-5 and cannot be recognized as an asset using this Topic. In accordance with paragraph 340-40-25-8, the entity recognizes the payroll expense for these two employees when incurred.

The guidance requires that if the costs incurred in fulfilling a contract do not give rise to an asset based on the criteria above, they must be expensed as incurred. The standard provides some common examples of costs that should be expensed as incurred as follows:

Excerpt from the Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Recognition

Costs to Fulfill a Contract

340-40-25-8

An entity shall recognize the following costs as expenses when incurred:

a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)

b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract

c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)

d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

If an entity is unable to determine whether certain costs relate to past or future performance, and the costs are not eligible for capitalization under other US GAAP guidance, the costs are expensed as incurred.

8.3.3 Amortization and impairment of capitalized costs

Any capitalized contract costs are ultimately amortized, with the expense recognized as the entity transfers the goods or services to the customer. It is important to note that certain capitalized costs will relate to multiple goods and services (e.g., design costs). For these costs, the amortization period could extend beyond a single contract if the capitalized costs relate to goods or services being transferred under multiple contracts, or to a specific anticipated contract, such as when the customer is expected to renew its current services contract for another term.

Illustration 8-3: Amortization period
Entity A enters into a three-year contract with a customer for transaction processing services. To fulfill the contract, Entity A incurred setup costs of $60,000, which it capitalized and will amortize over the term of the contract. At the beginning of the third year, the customer renews the contract for an additional two years. Because Entity A will benefit from the setup costs during the additional two-year period, it would change the remaining amortization period from one to three years and adjust the amortization expense recognized in accordance with the guidance in ASC 250 on changes in estimates. However, under the standard, if Entity A had anticipated the contract renewal at contract inception, Entity A would have amortized the setup costs over the anticipated term of the contract, including the expected renewal (i.e., five years).

Any asset recorded by the entity is subject to an impairment assessment at the end of each reporting period. That's because costs that give rise to an asset must continue to be recoverable throughout the arrangement to meet the criteria for capitalization. An impairment exists if the carrying amount of any asset(s) exceeds the amount of consideration the entity expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those good and services. Note that the amounts an entity expects to receive should be based on the principles for determining the transaction price (see Section 5), except for the guidance on constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the required constraint on variable consideration, it would use the unconstrained transaction price for the impairment test. While unconstrained, this amount must be reduced to reflect the customer's credit risk before it is used in the impairment test.

However, before recognizing an impairment loss on capitalized costs incurred to obtain or fulfill a contract, the entity will need to consider impairment losses recognized in accordance with another topic (e.g., ASC 330[24], ASC 985-20[25], ASC 360, ASC 350). After applying the impairment test to the capitalized costs, an entity includes the resulting carrying amount in the carrying amount of the asset group or reporting unit for purposes of applying the guidance in ASC 360 or ASC 350.

The Boards diverged on the reversal of impairment losses in subsequent periods. Under IFRS, the guidance permits the reversal of some or all of previous impairment losses if the estimates used to determine the asset's recoverable amount have changed. However, under US GAAP the reversal of impairment losses is prohibited.

8.4 Licenses of intellectual property

The standard provides guidance specific to the recognition of revenue for licenses of intellectual property, which differs slightly from the overall model for other promised goods and services. Licenses of intellectual property may include licenses of software and technology, media and entertainment products (e.g., motion pictures, music), franchises, patents, trademarks and copyrights.

The Boards concluded that specific criteria were necessary to determine the underlying nature of the entity's promise in granting the license (i.e., whether it is passed to the customer at a point in time or transferred to a customer over time). The Boards concluded that this additional guidance was necessary because they believed it was difficult to determine when a customer obtains control of assets in a license without first identifying the nature of the license and the entity's related performance obligations. These concepts are discussed further below.

8.4.1 Determining whether a license is distinct

The guidance provided on licenses of intellectual property is applicable only to licenses that are distinct. When the license is the only promised item (either explicitly or implicitly) in the contract, the guidance is applicable to that license.

However, licenses of intellectual property are frequently included in multiple-element arrangements with promises for additional goods and services that may be explicit or implicit. In these situations, an entity first determines whether the license of intellectual property is distinct, as discussed in Section 4.2. This includes assessing whether the customer can benefit from the license on its own or together with readily available resources. While licenses of intellectual property frequently are capable of being distinct, the customer in many cases can benefit from the license only when it is combined with another good or service. For example, a software license may be part of a software-enabled tangible good in which the software significantly influences the features and functionality of the tangible good. In addition, an entity may provide a customer with the license to software but only in conjunction with a hosting service, and the customer cannot use the software without the hosting. In both examples, the customer cannot benefit from the license on its own, and therefore, the license is not distinct and would be combined with those other promised goods or services.

For most licenses that are not distinct, an entity would follow the guidance for other goods and services to account for the combined performance obligation (i.e., the guidance in ASC 606-10-25-15 through 25-22 to determine whether the combined performance obligation transfers over time or at a point in time, as discussed in Sections 7.1 and 7.2).

However, in the Basis for Conclusions, the Boards noted that there may be some situations in which, even though the license is not distinct from the good or service transferred with the license, the license is the primary or dominant component of the combined item. In such situations, the Boards concluded that the incremental guidance for licenses of intellectual property should still be applied. However, the Boards did not provide guidance or examples for determining when a license is the primary or dominant component.

The standard includes the following example to illustrate the determination of whether a license is distinct:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 56 — Identifying a Distinct License

606-10-55-367

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product; therefore, the entity will not undertake any activities to support the drug, which is consistent with its customary business practices.

Case A — License Is Not Distinct

606-10-55-368

In this case, no other entity can manufacture this drug because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing services.

606-10-55-369

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.

606-10-55-370

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the performance obligation (that is, the bundle of the license and the manufacturing services) is a performance obligation satisfied at a point in time or over time.

Case B — License Is Distinct

606-10-55-371

In this case, the manufacturing process used to produce the drug is not unique or specialized, and several other entities can also manufacture the drug for the customer.

606-10-55-372

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. Because the manufacturing process can be provided by other entities, the entity concludes that the customer can benefit from the license on its own (that is, without the manufacturing service) and that the license is separately identifiable from the manufacturing process (that is, the criteria in paragraph 606-10-25-19 are met). Consequently, the entity concludes that the license and the manufacturing service are distinct and the entity has two performance obligations:

a. License of patent rights

b. Manufacturing service.

606-10-55-373

The entity assesses, in accordance with paragraph 606-10-55-60, the nature of the entity's promise to grant the license. The drug is a mature product (that is, it has been approved, is currently being manufactured, and has been sold commercially for the last several years). For these types of mature products, the entity's customary business practices are not to undertake any activities to support the drug. Consequently, the entity concludes that the criteria in paragraph 606-10-55-60 are not met because the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the intellectual property to which the customer has rights. In its assessment of the criteria in paragraph 606-10-55-60, the entity does not take into consideration the separate performance obligation of promising to provide a manufacturing service. Consequently, the nature of the entity's promise in transferring the license is to provide a right to use the entity's intellectual property in the form and the functionality with which it exists at the point in time that it is granted to the customer. Consequently, the entity accounts for the license as a performance obligation satisfied at a point in time.

606-10-55-374

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.

8.4.2 *Determining the nature of the entity's promise*

For all licenses of intellectual property determined to be distinct, an entity must then determine the nature of the promise to the customer. The standard states that entities provide their customers with either:

- A right to access the entity's intellectual property as it exists throughout the license period, including any changes to that intellectual property ("a right to access")
- A right to use the entity's intellectual property as it exists at the point in time in which the license is granted ("a right to use")

To determine whether a license is a right to access or a right to use the intellectual property (which is important when determining the period of performance and, therefore, the timing of revenue recognition), the Boards provided the following guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Determining the Nature of the Entity's Promise

606-10-55-59

To determine whether an entity's promise to grant a license provides a **customer** with either a right to access an entity's intellectual property or a right to use an entity's intellectual property, an entity should consider whether a customer can direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which the license is granted. A customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which the license is granted if the intellectual property to which the customer has rights changes throughout the license period. The intellectual property will change (and thus affect the entity's assessment of when the customer controls the license) when the entity continues to be involved with its intellectual property and the entity undertakes activities that significantly affect the intellectual property to which the customer has rights. In these cases, the license provides the customer with a right to access the entity's intellectual property (see paragraph 606-10-55-60). In contrast, a customer can direct the use of, and obtain substantially all of the remaining benefits from, the license at the point in time at which the license is granted if the intellectual property to which the customer has rights will not change (see paragraph 606-10-55-63). In those cases, any activities undertaken by the entity merely change its own asset (that is, the underlying intellectual property), which may affect the entity's ability to provide future licenses; however, those activities would not affect the determination of what the license provides or what the customer controls.

606-10-55-60

The nature of an entity's promise in granting a license is a promise to provide a right to access the entity's intellectual property if all of the following criteria are met:

a. The **contract** requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights (see paragraph 606-10-55-61).

b. The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph 606-10-55-60(a).

c. Those activities do not result in the transfer of a good or a service to the customer as those activities occur (see paragraph 606-10-25-17).

606-10-55-61

Factors that may indicate that a customer could reasonably expect that an entity will undertake activities that significantly affect the intellectual property include the entity's customary business practices, published policies, or specific statements. Although not determinative, the existence of a shared economic interest (for example, a sales-based royalty) between the entity and the customer related to the intellectual property to which the customer has rights may also indicate that the customer could reasonably expect that the entity will undertake such activities.

In providing this guidance, the Boards decided to focus on the characteristics of a license that is a right to provide access, and if the licensed intellectual property does not have those characteristics, it is a right to use license by default. This analysis is centered on situations in which the underlying intellectual property is subject to change over the license period.

The key determinant is whether the entity is required to undertake activities that affect the licensed intellectual property (or the customer has a reasonable expectation that the entity will do so), and whether the customer is therefore exposed to positive or negative effects resulting from those changes. Further, those activities undertaken by the entity do not meet the definition of a performance obligation. However, these activities can be part of an entity's ongoing and ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer). Further, the Boards noted in the Basis for Conclusions that the existence of a shared economic interest between the parties (e.g., sales- or usage-based royalties) may be an indicator that the customer has a reasonable expectation that the entity will undertake such activities.

It is important to note that when an entity is making this assessment, it must exclude the effects of any other performance obligations in the arrangement. For example, if an entity enters into an arrangement to license software and provide access to any future upgrades to that software during the license period, the entity first has to determine whether the license and the promise to provide future updates are separate performance obligations. If they are separate, when the entity considers whether it has a contractual (explicit or implicit) obligation to undertake activities to change the software during the license period, it would exclude any changes and activities associated with the promised future upgrades performance obligation.

The standard also provides the following guidance around making this determination:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Determining the Nature of the Entity's Promise

606-10-55-64

An entity should disregard the following factors when determining whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property:

a. Restrictions of time, geographical region, or use — Those restrictions define the attributes of the promised license, rather than define whether the entity satisfies its performance obligation at a point in time or over time.

b. Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use — A promise to defend a patent right is not a performance obligation because the act of defending a patent protects the value of the entity's intellectual property assets and provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

8.4.3 *Transfer of control of licensed intellectual property*

Based on whether the nature of the entity's promise is a right to access or a right to use the intellectual property, the arrangement consideration allocated to the licensed intellectual property should be recognized over the license period (for a right to access) or at the point in time the customer can first use the licensed intellectual property (for a right to use).

Right to access

The Boards concluded that a license that provides an entity with the right to access intellectual property is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance of providing access," including the related activities undertaken by entity. This conclusion is based on the determination that when a license is subject to change, and the customer is exposed to the positive or negative effects of that change, the customer is not able to fully gain control over the intellectual property at any given point in time but rather gains control over the license period.

The standard includes the following example of a right to access license:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 58 — Access to Intellectual Property

606-10-55-383

An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. There are main characters involved in each of the comic strips. However, newly created characters appear 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. The contract requires the customer to use the latest images of the characters.

606-10-55-384

In exchange for granting the license, the entity receives a fixed payment of $1 million in each year of the 4-year term.

606-10-55-385

In accordance with paragraph 606-10-25-19, the entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity concludes that it has no other performance obligations other than the promise to grant a license. That is, the additional activities associated with the license do not directly transfer a good or service to the customer because they are part of the entity's promise to grant a license and, in effect, change the intellectual property to which the customer has rights.

606-10-55-386

The entity assesses the nature of the entity's promise to transfer the license in accordance with paragraph 606-10-55-60. In assessing the criteria the entity considers the following:

a. The customer reasonably expects (arising from the entity's customary business practices) that the entity will undertake activities that will affect the intellectual property to which the customer has rights (that is, the characters). Those activities include development of the characters and the publishing of a weekly comic strip that includes the characters.

b. The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities because the contract requires the customer to use the latest characters.

c. Even though the customer may benefit from those activities through the rights granted by the license, they do not transfer a good or service to the customer as those activities occur.

606-10-55-387

Consequently, the entity concludes that the criteria in paragraph 606-10-55-60 are met and that the nature of the entity's promise to transfer the license is to provide the customer with access to the entity's intellectual property as it exists throughout the license period. Consequently, the entity accounts for the promised license as a performance obligation satisfied over time (that is, the criterion in paragraph 606-10-25-27(a) is met).

606-10-55-388

The entity applies paragraphs 606-10-25-31 through 25-37 to identify 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.

Right to use

In contrast, when the license represents a right to use the intellectual property as it exists at a specific point in time, the customer gains control over that intellectual property at the beginning of the time period for which it has the right to use the intellectual property. Note that this timing may differ from when the license was granted. For example, an entity may provide a customer with the right to use intellectual property but indicate that the right to use does not start until 30 days after the agreement is finalized. For purposes of determining when control transfers for rights to use, the Boards clarified that the assessment should be from the customer's perspective (i.e., when the customer can use the licensed intellectual property) rather than the entity's perspective (i.e., when the entity transfers the license).

The standard includes the following example of a right to use license:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 59 — Right to Use Intellectual Property

606-10-55-389

An entity, a music record label, licenses to a customer a 1975 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. 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.

606-10-55-390

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that its only performance obligation is to grant the license.

606-10-55-391

In accordance with paragraph 606-10-55-60, the entity assesses the nature of the entity's promise to grant the license. The entity does not have any contractual or implied obligations to change the licensed recording. Thus, the intellectual property to which the customer has rights is static. Consequently, the entity concludes that the nature of its promise in transferring the license is to provide the customer with a right to use the entity's intellectual property as it exists at the point in time that it is granted. Therefore, the promise to grant the license is a performance obligation satisfied at a point in time. The entity recognizes all of the revenue at the point in time when the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licensed intellectual property.

606-10-55-392

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.

8.4.4 Sales- or usage-based royalties on licenses of intellectual property

The standard also provides guidance on the determination of the transaction price when the arrangement includes sales- or usage-based royalties on licenses of intellectual property. The standard requires that this particular type of variable consideration not be included in the estimate of variable consideration, as discussed in Section 5.1. An entity should recognize these amounts only upon the *later* of when the sale or usage occurs or the satisfaction (in whole or in part) of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

Note that this guidance is applicable to all licenses of intellectual property, regardless of whether they have been determined to be distinct. However, the guidance is not applicable to all arrangements involving sales- or usage-based royalties. It applies only to sales- or usage-based royalties related to licenses of intellectual property.

The standard includes the following example relating to sales- and usage-based royalties:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 57 — Franchise Rights

606-10-55-375

An entity enters into a contract with a customer and promises to grant a franchise license that provides the customer with the right to use the entity's trade name and sell the entity's products for 10 years. In addition to the license, the entity also promises to provide the equipment necessary to operate a franchise store. In exchange for granting the license, the entity receives a sales-based royalty of 5 percent of the customer's monthly sales. The fixed consideration for the equipment is $150,000 payable when the equipment is delivered.

Identifying Performance Obligations

606-10-55-376

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the entity, as a franchisor, has developed a customary business practice to undertake activities such as analyzing the customer's 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 because they are part of the entity's promise to grant a license and, in effect, change the intellectual property to which the customer has rights.

606-10-55-377

The entity determines that it has two promises to transfer goods or services: a promise to grant a license and a promise to transfer equipment. In addition, the entity concludes that the promise to grant the license and the promise to transfer the equipment are distinct. This is because the customer can benefit from each promise (that is, the promise of the license and the promise of the equipment) on their own or together with other resources that are readily available (see paragraph 606-10-25-19(a)). (That is, 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 franchise license and equipment are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b), because none of the factors in paragraph 606-10-25-21 are present. Consequently, the entity has two performance obligations:

a. The franchise license

b. The equipment.

Allocating the Transaction Price

606-10-55-378

The entity determines that the transaction price includes fixed consideration of $150,000 and variable consideration (5 percent of customer sales).

606-10-55-379

The entity applies paragraph 606-10-32-40 to determine whether the variable consideration should be allocated entirely to the performance obligation to transfer the franchise license. The entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the franchise license because the variable consideration relates entirely to the entity's promise to grant the franchise license. In addition, the entity observes that allocating $150,000 to the equipment and the sales-based royalty to the franchise license would be consistent with an allocation based on the entity's relative standalone selling prices in similar contracts. That is, the standalone selling price of the equipment is $150,000 and the entity regularly licenses franchises in exchange for 5 percent of customer sales. 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

606-10-55-380

The entity assesses, in accordance with paragraph 606-10-55-60, the nature of the entity's promise to grant the franchise license. The entity concludes that the criteria in paragraph 606-10-55-60 are met and the nature of the entity's promise is to provide access to the entity's intellectual property in its current form throughout the license period. This is because:

a. The entity concludes that the customer would reasonably expect that the entity will undertake activities that will affect the intellectual property to which the customer has rights. This is on the basis of the entity's customary business practice to undertake activities such as analyzing the customer's changing preferences and implementing product improvements, pricing strategies, marketing campaigns, and operational efficiencies. In addition, the entity observes that because part of its compensation is dependent on the success of the franchisee (as evidenced through the sales-based royalty), the entity has a shared economic interest with the customer that indicates that the customer will expect the entity to undertake those activities to maximize earnings.

b. The entity also observes that the franchise license requires the customer to implement any changes that result from those activities and thus exposes the customer to any positive or negative effects of those activities.

c. The entity also observes that even though the customer may benefit from the activities through the rights granted by the license, they do not transfer a good or service to the customer as those activities occur.

606-10-55-381

Because the criteria in paragraph 606-10-55-60 are met, the entity concludes that the promise to transfer the license is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27(a).

606-10-55-382

The entity also concludes that because the consideration is in the form of a sales-based royalty, the entity applies paragraph 606-10-55-65 and, after the transfer of the franchise license, the entity recognizes revenue as and when those sales occur.

9 Presentation and disclosure

The new standard provides explicit guidance on presentation that applies to both public and nonpublic entities. As discussed previously, it defines a public entity as one of the following:

- A public business entity
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files or furnishes financial statements with the SEC

An entity that does not meet these criteria is considered a nonpublic entity for purposes of this standard.

The standard's disclosure requirements differ for public and nonpublic entities. Further, the interim disclosure requirements for US GAAP reporting entities differ from the requirements for IFRS reporting entities. These topics are discussed in more detail below.

Note that the disclosure requirements discussed in these sections are required on an ongoing basis. Disclosures required as part of the transition to the new guidance are discussed in Section 1.2.

9.1 Presentation — Contract assets, contract liabilities and revenue

The new model is based on the notion that a contract asset or contract liability is generated when either party to a contract performs. The guidance requires that an entity present these contract assets or contract liabilities in the statement of financial position.

When an entity satisfies a performance obligation by delivering the promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first, for example, by prepaying its promised consideration, the entity has a contract liability.

In many cases, the entity has an unconditional right to receive the consideration from the customer. This is the case when there are no further performance obligations required to be satisfied before the entity has the right to collect the customer's consideration. The Boards concluded that an unconditional right to receive the customer's consideration represents a receivable from the customer that should be classified separately from contract assets. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due.

Contract assets exist when an entity has satisfied a performance obligation but does not yet have an unconditional right to consideration (e.g., because the entity first must satisfy another performance obligation in the contract before it is entitled to invoice the customer).

Under the new standard, entities are not required to use the terms "contract asset" or "contract liability" but must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (a receivable) and conditional rights to receive consideration (a contract asset).

After initial recognition, receivables and contract assets are subject to an impairment assessment in accordance with ASC 310 on receivables. In addition, if upon initial measurement there is a difference between the measurement of the receivable under ASC 310 and the corresponding amount of revenue, that difference will be presented as an expense (e.g., as an impairment loss). Based on the discussion in Section 5.1.1 on how collectibility should be considered in determining the transaction price, it appears there may

be a difference between the measurement of the receivable and the corresponding revenue when an entity determines that such a difference reflects something other than an implied price concession, such as customer credit risk. Impairment losses resulting from contracts with customers are presented separately from other contracts.

An entity could also have recorded other assets (e.g., the incremental costs of obtaining the contract and other costs incurred that meet the criteria for capitalization). The guidance requires that any such assets be presented separately from contract assets and contract liabilities in the statement of financial position (assuming that they are material). These amounts are also assessed for impairment separately (see Section 8.3.3).

The new standard also requires revenue from contracts with customers be presented or disclosed separately from the entity's other sources of revenue. For example, a large equipment manufacturer that both sells and leases its equipment should present amounts from these transactions separately.

How we see it

The presentation requirements represent a significant change from current practice. In addition, applying the notion of a contract asset and any impairment of that asset may generate questions.

9.2 Disclosures

In response to criticism that today's revenue recognition disclosures are inadequate, the Boards sought to create a comprehensive and coherent set of disclosures. As a result, and to be consistent with other recent standards, the guidance includes an overall objective for these disclosures, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

606-10-50-1

The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

a. Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)

b. The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)

c. Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).

Each of these disclosure topics is discussed further below. Because the disclosure requirements differ for public companies and nonpublic companies, these topics are discussed in Section 9.3 for public companies and Section 9.4 for nonpublic companies. To assist entities in determining the required disclosures, Appendices A and B include excerpts from EY's US GAAP Disclosure Checklist for public and nonpublic entities, respectively.

During the development of the new standard, many preparers raised concerns that they would need to provide voluminous disclosures at a cost that may outweigh any potential benefits. In the final standard, the Boards clarified the standard's disclosure objective and said the disclosures described in the guidance are not meant to be a checklist of minimum requirements. That is, entities do not have to include disclosures that are not relevant or are not material to them. In addition, the Boards decided to require qualitative disclosures instead of tabular reconciliations for certain disclosures.

The disclosures are required for and as of each annual period for which a statement of comprehensive income and a statement of financial position are presented. Interim disclosures are also required for entities preparing interim financial statements, although the required interim disclosures will differ under US GAAP and IFRS. While the IASB amended IAS 34, *Interim Financial Reporting*, to require disaggregated revenue information, none of the other annual disclosures will be required in the interim financial statements for IFRS preparers.

However, the FASB amended ASC 270[26] to require the same quantitative disclosures about revenue in interim financial statements as in the annual financial statements. While ASC 270 already required companies to disclose information about changes in financial position and performance since the last annual reporting period, the FASB decided that specifying the revenue-related disclosures required in companies' interim financial statements will reduce the risk of entities reaching different conclusions about what represents a significant change and how information about that change should be presented in interim financial statements. In reaching this conclusion, the FASB observed that an entity has much of the information required for the disclosures on an interim basis readily available, and disclosing that information may not raise costs significantly.

How we see it

As discussed more fully below, the new guidance significantly increases the volume of required disclosures in entities' interim and annual financial statements. While some of the required disclosures are consistent with those included in the recently revised multiple-element arrangements guidance (i.e., the disclosures pertaining to the significant judgments made in applying the model), many are completely new requirements.

Non-issuer entities that historically have not considered themselves "public entities" may get caught in the standard's expanded definition of a public entity (e.g., entities whose financial statements are included in a registrant's SEC filing because they are significant acquirees under Rule 3-05 of Regulation S-X). As a result, these entities would be subject to the more expansive disclosure requirements applicable to public entities. Also, an entity that may, at some point in the future, fall within the standard's expanded definition of a public entity will be required to follow the public company disclosure requirements.

Entities may need to expend extra effort when initially preparing the required disclosures for their interim and annual financial statements. For example, entities operating in multiple segments with many different product lines may find it challenging to gather the data needed to provide the disclosures. As a result, entities will need to ensure that they have the appropriate systems, internal controls, policies and procedures in place to collect and disclose the required information. In light of the expanded disclosure requirements and the potential need for new systems to capture the data needed for these disclosures, entities may wish to prioritize this portion of their implementation plans.

9.3 Disclosures for public entities

9.3.1 Contracts with customers

The majority of the disclosures relate to an entity's contracts with customers. These disclosures include disaggregation of revenue, information about contract asset and liability balances, and information about an entity's performance obligations.

Disaggregation of revenue

The disclosure requirements begin with revenue disaggregated into categories to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Entities are not required to disaggregate losses for uncollectible amounts. While the standard does not specify how the revenue should be disaggregated, the implementation guidance suggests categories as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Disclosure of Disaggregated Revenue

606-10-55-91

Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)

b. Geographical region (for example, country or region)

c. Market or type of customer (for example, government and nongovernment customers)

d. Type of contract (for example, fixed-price and time-and-materials contracts)

e. Contract duration (for example, short-term and long-term contracts)

f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

The implementation guidance indicates that the most appropriate categories for a particular entity will depend on its facts and circumstances, but an entity should consider how it disaggregates revenue in other communications (e.g., press releases, other public filings) when determining which categories are most relevant and useful.

The Boards decided not to prescribe a specific characteristic of revenue as the basis for disaggregation because they intend for entities to make this determination based on entity- and/or industry-specific factors that would be most meaningful for their businesses. The Boards acknowledged that an entity may need to use more than one type of category to disaggregate its revenue.

The Boards also clarified that an entity does not have to duplicate disclosures required by another standard. For example, an entity that provides disaggregated revenue disclosures as part of its segment disclosures does not have to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors and are presented on a basis consistent with US GAAP. However, if separate disaggregated revenue disclosures are provided, the new standard requires an entity to explain the relationship between the disaggregated revenue information and the segment information. Users of the financial statements said this information is critical to their ability to understand not only the composition of revenue but also how revenue relates to other information provided in the segment disclosures. Entities can provide this information in a tabular or a narrative form.

The Boards provided some examples of disaggregation of revenue disclosures as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 41 — Disaggregation of Revenue — Quantitative Disclosure

606-10-55-296

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).

606-10-55-297

The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 606-10-50-5, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation, and energy segments in accordance with paragraphs 606-10-50-6.

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

Contract balances

The Boards concluded that users of the financial statements need to understand the relationship between the revenue recognized and changes in the overall balances of an entity's total contract assets and liabilities during a particular reporting period. As a result, the Boards included disclosure requirements for an entity's contracts with its customers in the standard as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Contract Balances

606-10-50-8

An entity shall disclose all of the following:

a. The opening and closing balances of receivables, **contract assets**, and **contract liabilities** from **contracts** with **customers**, if not otherwise separately presented or disclosed

b. **Revenue** recognized in the reporting period that was included in the contract liability balance at the beginning of the period

c. Revenue recognized in the reporting period from **performance obligations** satisfied (or partially satisfied) in previous periods (for example, changes in **transaction price**).

606-10-50-9

An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

606-10-50-10

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

The requirements listed above will likely be new disclosures for most entities. The illustration below is an example of how an entity may fulfill these requirements:

Illustration 9-1: Contract asset and liability disclosures

Company A discloses trade receivables separately in the statement of financial position. In order to comply with the remainder of the required disclosures pertaining to contract assets and liabilities, Company A includes the following information in the footnotes to the financial statements:

	20X8	**20X7**	**20X6**
Contract asset	$ 1,500	$ 2,250	$ 1,800
Contract liability	(200)	(850)	(500)

	20X8	**20X7**	**20X6**
Revenue recognized in the period from:			
Amounts included in contract liability at the beginning of the period	$ 650	$ 200	$ 100
Performance obligations satisfied in previous periods	$ 200	$ 125	$ 200

We receive payments from customers based on a billing schedule as established in our contracts. Contract asset relates to cost incurred to perform in advance of scheduled billings. Contract liability relates to payments received in advance of performance under the contract. Changes in contract asset and liability are due to our performance under the contract. In addition, a contract asset decreased in 20X8 due to a contract asset impairment of $400 relating to an early cancellation of a contract with a customer.

Performance obligations

To help users of financial statements analyze the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, the Boards decided to require

a separate disclosure of an entity's remaining performance obligations. A public entity is also required to disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when it expects to recognize the amount(s) in its interim and annual financial statements.

Both quantitative and qualitative information is required, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Performance Obligations

606-10-50-12

An entity shall disclose information about its **performance obligations** in **contracts** with **customers**, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

Transaction Price Allocated to the Remaining Performance Obligations

606-10-50-13

An entity shall disclose the following information about its remaining **performance obligations**:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as **revenue** the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:

   1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

   2. By using qualitative information.

In the Basis for Conclusions, the Boards noted that many financial statements users commented that information about the amount and timing of revenue that an entity expects to recognize from its existing contracts would be useful in their analyses of revenue, especially for long-term contracts with significant unrecognized revenue. The Boards also observed that a number of

entities often voluntarily disclose such "backlog" information. However, this information typically is presented outside the financial statements and may not be comparable across entities because there is not a common definition of backlog. As summarized in the Basis for Conclusions, the Boards' goal in including the disclosure requirements in ASC 606-10-50-13 is to provide users of an entity's financial statements with additional information about the following:

a. The amount and expected timing of revenue to be recognized from the remaining performance obligations in existing contracts

b. Trends relating to the amount and expected timing of revenue to be recognized from the remaining performance obligations in existing contracts

c. Risks associated with expected future revenue (for example, some observe that revenue is more uncertain if an entity does not expect to satisfy a performance obligation until a much later date)

d. The effect of changes in judgments or circumstances on an entity's revenue

This disclosure can be provided on either a quantitative basis (e.g., amounts to be recognized in given time bands, such as between one and two years or between two and three years) or by disclosing a mix of quantitative and qualitative information. This disclosure does not include consideration attributable to contract renewal options (that do not represent a material right) and any estimated amounts of variable consideration that are constrained and not included in the transaction price. However, any significant renewals and variable consideration not included in the estimate of the transaction price should be disclosed.

The Boards also provided a practical expedient under which an entity can avoid disclosing the amount of the remaining performance obligations for contracts with an original expected duration of less than one year or those that permit the entity to recognize revenue as invoiced. For example, an entity is not required to make the disclosure for a three-year service contract under which it has a right to invoice the customer a fixed amount for each hour of service provided.

The standard provides the following examples for these required disclosures:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 42 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations

606-10-55-298

On June 30, 20X7, an entity enters into three contracts (Contracts A, B, and C) with separate customers to provide services. Each contract has a two-year noncancellable term. The entity considers the guidance in paragraphs 606-10-50-13 through 50-15 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at December 31, 20X7.

Contract A

606-10-55-299

Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of $25.

606-10-55-300

Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph 606-10-55-18. Consequently, no disclosure is necessary if the entity elects to apply the practical expedient in paragraph 606-10-50-14(b).

Contract B

606-10-55-301

Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of $400 per month for both services. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

606-10-55-302

The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The information for Contract B included in the overall disclosure is as follows.

	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 x 12 months

(b) $2,400 = $400 x 6 months

Contract C

606-10-55-303

Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of $100 per month plus a one-time variable consideration payment ranging from $0 — $1,000 corresponding to a one-time regulatory review and certification of the customer's facility (that is, a performance bonus). The entity estimates that it will be entitled to $750 of the variable consideration. On the basis of the entity's assessment of the factors in paragraph 606-10-32-12, the entity includes its estimate of $750 of variable consideration in the transaction price because it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

606-10-55-304

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.

Example disclosure:

	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 x 24 months 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)

606-10-55-305

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.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Implementation Guidance and Illustrations

Example 43 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations — Qualitative Disclosure

606-10-55-306

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.

606-10-55-307

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.

9.3.2 *Significant judgments*

The guidance requires specific disclosure of significant accounting estimates and judgments made in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied. These requirements exceed those in today's general guidance on significant accounting estimates and are discussed in more detail below.

Determining the transaction price and the amounts allocated to performance obligations

Entities often exercise significant judgment when estimating the transaction prices of their contracts, especially when those estimates involve variable consideration.

Further, significant judgment may be required when estimating standalone selling prices. The standard requires public entities to disclose qualitative information about the methods, inputs and assumptions used in their annual financial statements. The Boards concluded this was important so users could assess the quality of earnings.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Transaction Price and the Amounts Allocated to Performance Obligations

606-10-50-20

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the **transaction price**, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration

b. Assessing whether an estimate of variable consideration is constrained

c. Allocating the transaction price, including estimating **standalone selling prices** of promised goods or services and allocating discounts and variable consideration to a specific part of the **contract** (if applicable)

d. Measuring obligations for returns, refunds, and other similar obligations.

Determining the timing of satisfaction of performance obligations

The guidance also requires entities to provide disclosures about the significant judgments made in determining the timing of satisfaction of performance obligations. For performance obligations that are satisfied over time, public entities must disclose the following information, as described in the new guidance:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Timing of Satisfaction of Performance Obligations

606-10-50-18

For **performance obligations** that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize **revenue** (for example, a description of the output methods or input methods used and how those methods are applied)

b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

For performance obligations that are satisfied at a point in time, public entities should disclose the significant judgments made in evaluating at what point the customer obtains control of the goods or services.

9.3.3 *Assets recognized from the costs to obtain or fulfill a contract*

The standard (through conforming amendments to ASC 340) requires entities to disclose information about assets recognized from the costs to obtain or fulfill a contract because that information is intended to help users understand the types of costs recognized as assets and how those assets are subsequently amortized or impaired. These disclosures are:

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs — Contracts with Customers

Disclosure

Assets Recognized from the Costs to Obtain or Fulfill a Contract with a Customer

340-40-50-2

An entity shall describe both of the following:

a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5)

b. The method it uses to determine the amortization for each reporting period.

340-40-50-3

a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)

b. The amount of amortization and any impairment losses recognized in the reporting period.

9.3.4 *Practical expedients*

The standard allows entities to use several practical expedients. Because applying these practical expedients may result in financial results that are different from a full application of the standard, public entities are required to disclose their use of practical expedients in their interim financial statements in the year of adoption and in their annual financial statements thereafter. That is, if an entity elects to use the practical expedient associated with the determination of whether a significant financing component exists (see Section 5.3) or the expedient pertaining to the incremental costs of obtaining a contract with a customer (see Section 8.3.1), the entity must disclose that fact.

9.4 Disclosure for nonpublic entities

Under the new standard, nonpublic entities can choose to provide all of the disclosures required for public entities or to provide streamlined disclosures. The following is a discussion of the streamlined disclosure requirements for nonpublic entities that elect this option.

9.4.1 *Contracts with customers*

Disclosures related to an entity's contracts with customers will likely compose a significant portion of the required disclosures. These disclosures include disaggregation of revenue, contract asset and liability balances, and information about an entity's performance obligations.

Disaggregation of revenue

Nonpublic entities are required to provide quantitative disclosures about revenue, disaggregated based on the timing of transfer of goods or services (e.g., revenue recognized at a point in time and revenue recognized over time) in their interim and annual financial statements, as applicable. Nonpublic entities also are required to provide certain qualitative information in their interim and annual financial statements, as applicable. The qualitative disclosures should address how economic factors (e.g., type of customer, geographical location of customers, type of contract) affect revenue and cash flows.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Disaggregation of Revenue

606-10-50-5

An entity shall disaggregate **revenue** recognized from **contracts** with **customers** into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

606-10-50-6

In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

606-10-50-7

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission (SEC), may elect not to apply the quantitative disaggregation disclosure guidance in paragraphs 606-10-50-5 through 50-6 and 606-10-55-89 through 55-91. If an entity elects not to provide those disclosures, the entity shall disclose, at a minimum, revenue disaggregated according to the timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time) and qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Contract balances

The FASB believes users of the financial statements need to understand the relationship between revenue recognized and changes in the overall balances of an entity's total contract assets and liabilities during a particular reporting period. As a result, the standard requires nonpublic entities to disclose the opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers. This requirement likely will result in new disclosures for most entities.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Contract Balances

606-10-50-8

An entity shall disclose all of the following:

a. The opening and closing balances of receivables, **contract assets**, and **contract liabilities** from **contracts** with **customers**, if not otherwise separately presented or disclosed

b. **Revenue** recognized in the reporting period that was included in the contract liability balance at the beginning of the period

c. Revenue recognized in the reporting period from **performance obligations** satisfied (or partially satisfied) in previous periods (for example, changes in **transaction price**).

606-10-50-9

An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

606-10-50-10

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

606-10-50-11

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide any or all of the disclosures in paragraphs 606-10-50-8 through 50-10. However, if an entity elects not to provide the disclosures in paragraphs 606-10-50-8 through 50-10, the entity shall provide the disclosure in paragraph 606-10-50-8(a), which requires the disclosure of the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed.

Performance obligations

To help users of financial statements analyze the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, the FASB decided to require a separate disclosure of an entity's remaining performance obligations. The required information is both quantitative and qualitative.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Performance Obligations

606-10-50-12

An entity shall disclose information about its **performance obligations** in **contracts** with **customers**, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

Transaction Price Allocated to the Remaining Performance Obligations

606-10-50-13

An entity shall disclose the following information about its remaining **performance obligations**:

a. The aggregate amount of the **transaction price** allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as **revenue** the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:

    1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

    2. By using qualitative information.

606-10-50-14

As a practical expedient, an entity need not disclose the information in paragraph 606-10-50-13 for a performance obligation if either of the following conditions is met:

a. The performance obligation is part of a **contract** that has an original expected duration of one year or less.

b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18.

606-10-50-15

An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 606-10-50-14 and whether any consideration from with customers is not included in the transaction price and, therefore, not included in **contracts** the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

606-10-50-16

An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide the disclosures in paragraphs 606-10-50-13 through 50-15.

9.4.2 Significant judgments

The guidance also requires the disclosure of significant accounting estimates and judgments made in determining the transaction price, allocating the transaction price to performance obligations and determining the satisfaction of performance obligations. These disclosure requirements exceed the requirements in the general guidance on significant accounting estimates currently required under US GAAP and are discussed in more detail below.

Determining the transaction price and the amounts allocated to performance obligations

The standard requires nonpublic entities to disclose qualitative information about the methods, inputs and assumptions used in estimating the transaction prices of the entity's contracts and the allocation of that transaction price.

Determining the timing of satisfaction of performance obligations

The guidance requires nonpublic entities to provide disclosures about the significant judgments made in determining the timing of satisfaction of performance obligations. For performance obligations that are satisfied over time, nonpublic entities must disclose the methods used to recognize revenue (e.g., a description of the output method, a description of the input method).

Specifically, the standard requires the following disclosures:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Disclosure

Determining the Timing of Satisfaction of Performance Obligations

606-10-50-18

For **performance obligations** that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize **revenue** (for example, a description of the output methods or input methods used and how those methods are applied)

b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

606-10-50-19

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a **customer** obtains control of promised goods or services.

Determining the Transaction Price and the Amounts Allocated to Performance Obligations

606-10-50-20

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the **transaction price**, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration

b. Assessing whether an estimate of variable consideration is constrained

c. Allocating the transaction price, including estimating **standalone selling prices** of promised goods or services and allocating discounts and variable consideration to a specific part of the **contract** (if applicable)

d. Measuring obligations for returns, refunds, and other similar obligations.

606-10-50-21

An entity except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the SEC, may elect not to provide any or all of the following disclosures:

a. Paragraph 606-10-50-18(b), which states that an entity shall disclose, for **performance obligations** satisfied over time, an explanation of why the methods used to recognize **revenue** provide a faithful depiction of the transfer of goods or services to a **customer**

b. Paragraph 606-10-50-19, which states that an entity shall disclose, for performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services

c. Paragraph 606-10-50-20, which states that an entity shall disclose the methods, inputs, and assumptions used to determine the transaction price and to allocate the transaction price. However, if an entity elects not to provide the disclosures in paragraph 606-10-50-20, the entity shall provide the disclosure in paragraph 606-10-50-20(b), which states that an entity shall disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

10 Implementation considerations

The new standard will likely affect the measurement, recognition and disclosure of revenue, which is often the most important financial performance indicator. Gaining an understanding of the effects of the new standard, providing early communication to stakeholders and planning ahead are crucial for a successful implementation. Even entities that do not expect significant changes in the measurement and timing of revenue will need to validate that assumption and identify any necessary changes to policies, procedures, internal controls and systems to ensure that revenue transactions are appropriately evaluated through the lens of the new model. In addition, entities need to plan for the significantly expanded disclosure requirements. For entities that will experience a significant change in revenue recognition as a result of the new standard, the implementation effort will be considerable, and entities should start planning as soon as possible. Early preparation is the key to a smooth transition. This section addresses factors that entities should consider as they begin to implement the new standard.

10.1 Not just an accounting change

Since an entity's objective is to generate revenue, it is not surprising that changes to the accounting for revenue could affect multiple business functions. The chart below highlights actions entities should consider taking:

Control environment	Investor relations	Processes and systems
‣ Adjust or add controls to address increased judgments and estimates in revenue amounts, including documentation and testing of those new controls ‣ Update policies and procedures to conform to the new standard ‣ Consider internal controls optimization for all revenue-related controls	‣ Consider early education on impact for key constituents ‣ Anticipate potential changes to underlying key metrics, including gross margins ‣ Benchmark relative to global peer group to understand any differences in effects	‣ Update key processes and controls for any changes in how transactions are accounted for under new standard ‣ Develop IT systems and manual processes for data accumulation and expanded reporting requirements ‣ Plan for financial statement presentation changes, including expanded footnote disclosures
Training and communication	**Employee benefits**	**Tax planning**
‣ Plan and deliver training for finance, operations, business and IT staff ‣ Develop communication plan for affected internal functions and external stakeholders	‣ Align compensation plans with new revenue model, including revising commission structures and terms of share-based payment arrangements	‣ Identify any impact on existing tax strategies and planning ‣ Consider whether any changes to transfer pricing are necessary ‣ Manage any necessary integration with new revenue systems implemented in response to the new standard
Management information	**Business operations**	**Project management**
‣ Plan for potential adjustments to key performance indicators ‣ Consider changes to internal management reporting to better align with new external disclosures ‣ Adjust financial planning and analysis based on effects of the new standard	‣ Modify contracting procedures ‣ Understand any effects on existing regulatory requirements ‣ Communicate information needed for estimates and judgment to finance function ‣ Monitor potential effects on covenants during implementation	‣ Develop a comprehensive project management function, involve executives extensively, and provide appropriate resources and budgets

10.2 Implementing accounting change

Adopting the new model for measuring and recognizing revenue may seem daunting. The effects of the new standard reach beyond the finance function and, in some cases, may affect the way relationships with customers are structured. Users of financial statements analyze revenue very closely, so entities should focus on establishing effective revenue recognition policies and practices that will provide a solid foundation in the future.

A common model for implementing accounting change in an organization includes the following five phases:

- **Assessment** — Identify accounting, reporting, and tax differences and consequences on business processes and systems
- **Design and planning** — Set up project infrastructure and management, including road map and change management strategy
- **Solution development** — Identify solutions, prepare implementation plan and develop solutions across workstreams
- **Implementation** — Approve and roll out solutions across workstreams
- **Post-implementation** — Address deferred items and transition to operational model

As a result of the potential wide-ranging effects of the new standard, the implementation effort should be comprehensive and include several functions outside of the traditional finance function, including IT, legal, sales, marketing, human resources, investor relations and the C-suite. The related workstreams that should be considered in this effort include:

- Accounting and reporting
- Tax
- Business processes and systems
- Change management, communication and training

In addition, a strong project management function will be critical to keep these workstreams running smoothly and on schedule.

Below we provide some additional insights into the assessment phase. However, we have not expanded on the remaining four phases in this publication because the assessment phase serves as a driver of each of the other phases, and the other phases are significantly influenced by the facts and circumstances of each entity.

10.3 Assessment phase

10.3.1 Scoping

The assessment, or diagnostic, phase is perhaps the most critical of the five phases for implementing an accounting change because it lays the foundation for the rest of the implementation effort. In this phase, an entity should understand the new guidance and determine the effect of the new standard on the entity’s significant revenue streams. Because the effects may vary by transaction type, entities should identify significant, unique revenue streams within the organization and apply the new standard to a sample of representative contracts for each transaction type.

To identify its significant and unique revenue streams, an entity generally will look at its product and service offerings. An entity may identify these revenue streams by considering the revenue recognition literature it applies today (e.g., multiple-element arrangements, long-term contracts, software, films or general guidance under SAB Topic 13). Entities also should consider whether additional factors such as geography, type of contract or sales channels could affect its determination of significant, unique revenue streams. For example, consider an entity that sells Products A, B and C directly to its customers in the US but uses resellers in Europe. In that situation, the entity should evaluate whether it should analyze six revenue streams, rather than just three based on the number of products.

10.3.2 *Assessment phase activities*

Once an entity has identified its significant revenue streams, it should apply the new standard to representative arrangements within each revenue stream, as well as consider the related effects on systems, processes, income taxes and change management. Sample procedures under each workstream include:

Accounting and reporting	Tax	Business processes and systems	Change management and communication
▸ Understand the requirements of the new standard, train the finance function and assess the potential impact on the entity	▸ Understand the effects of the new standard on the tax function	▸ Understand the overall process and system landscapes of the entity related to revenue (current and future)	▸ Understand the entity's organizational knowledge structure and knowledge management approach
▸ Identify differences between current standards and the new standard by applying the new standard to representative revenue arrangements	▸ Identify new deferred tax items as a result of the new standard	▸ Inventory all potential accounting differences from the Accounting and Reporting and Tax workstreams	▸ Develop considerations for communication protocols
▸ Identify additional disclosure requirements in the new standard	▸ Identify areas where entity's current tax accounting policies (i.e., policies applied in the entity's tax returns) will be affected by the new standard, including transfer pricing	▸ Determine process/functional areas most affected by the new standard (processes, systems and people) through gap analysis	▸ Develop an overall training road map to embed knowledge of the new standard in the organization
▸ Identify accounting and reporting areas requiring further investigation and evaluation that could be addressed in the next phase of the project	▸ Determine nature of effects of the new standard on tax compliance and planning	▸ Identify current and planned system and process initiatives and assess the effects of implementing the new standard	

10.3.3 Significant judgments and estimates

While performing the activities in the assessment phase, an entity should identify the key judgments and estimates that it will be required to make under the new standard. These management judgments and estimates will be an important part of implementing the new standard. The new model's use of broader principles, rather than more detailed prescriptive guidance, will require more estimates and judgment than under today's guidance. The following aspects of the new model are examples of areas requiring significant judgment:

- Identifying the contract
  - Collectibility (Section 3.1.5)
  - Combining contracts (Section 3.2)
  - Contract modifications (Section 3.3)
- Identifying performance obligations — determining distinct goods and services (Section 4.2)
- Determining the transaction price
  - Estimating variable consideration, including the constraint (Sections 5.1 and 5.2)
  - Significant financing component (Section 5.3)
- Estimating standalone selling prices (Section 6.1)
- Determining whether performance obligations are satisfied over time or as of a point in time (Sections 7.1 and 7.2)
- Determining whether licenses represent a right to use intellectual property or access to intellectual property over time (Section 8.4)

In the later phases of the implementation effort, an entity should design and implement processes to make these judgments to ensure consistency across the organization, as well as related controls.

10.3.4 Assessment phase outputs

In addition to identifying the significant judgments and estimates that will be required under the new standard, the assessment phase also should provide other valuable insights that will serve as the foundation for the remaining implementation phases. At the conclusion of this phase, an entity should be able to answer the following questions about its significant revenue types under the new standard and its implementation approach:

- **Will the entity apply a full retrospective or modified retrospective transition method?**

  As discussed in more detail in Section 1.2, the new standard allows two different transition methods. Before determining which option is right for an entity, management should be sure to identify the significant effects of the new standard on the entity's revenue streams, peers' expected adoption methods and stakeholder perspectives.

  - What method are peers and others within the sector applying?
  - What are analysts' views on transition methods for the sector and business model?

  - Will the entity have a significant amount of "lost" revenue as a result of the transition from current accounting policies to the new guidance (e.g., amounts of revenue that were deferred as of the adoption date of the new standard and will ultimately be reflected in the recast prior periods or as part of the cumulative adjustment upon adoption, but are never reported as revenue in a current period within the financial statements)?
  - If the entity applies the full retrospective method:
    - Does the entity have the ability to determine the transition adjustment as of 1 January 2015 and begin tracking financial information to be able to report information for the earliest periods presented?
    - Does the entity understand the effects on tax filings and subsidiary statutory financial statements?
  - If the entity applies the modified retrospective method:
    - Does the entity have the ability to maintain financial records under the new guidance and current GAAP in order to provide the required disclosures in the year of transition?
    - Would there be significant differences in the financial information presented on the face of the financial statements under the new guidance and the amount presented in the footnotes under current GAAP in the year of transition?

- **Which significant performance metrics will be affected?**

  Affected metrics will likely include gross margin, net income, EBITDA, earnings per share and operating cash flow. Once an entity understands the effects on its significant revenue streams, it should examine these metrics to determine whether any changes are appropriate, including, but not limited to, changes to any compensation programs tied to revenue (e.g., sales commissions, bonus programs), debt covenants and financial planning and analysis targets.

  - What performance metrics are tied to revenue? Is the entity considering changing compensation packages or other areas of the business that are tied to revenue?
  - Will changes in revenue affect any contractual covenants of the business?

- **Has the entity determined what changes are required to accounting systems and processes?**

  An entity will need to consider whether its IT systems and related general ledger and reporting software are able to track, compile and report information in accordance with the new revenue standard. For example, accounting for multiple performance obligations, estimates and judgments involving variable consideration and significant financing components; determining standalone selling prices; allocating the transaction price to the performance obligations; and measuring progress for performance obligations satisfied over time are just a few of the potential changes for some entities that could require new automated solutions.

In addition, an entity's systems will have to have the ability to capture or aggregate information to support the expanded quantitative and qualitative disclosure requirements, including:

- Disaggregated revenue information
- Transaction price allocated to remaining performance obligations
- Measurement of revenue using input methods for performance obligations satisfied over time

When performing this analysis, an entity may determine that it will need to gather more financial data and customer contract details than it currently collects. This may be challenging for an entity with decentralized operations that will need to accumulate information from multiple locations.

- **Are there plans to change the way the entity does business?**

  Many entities historically have required disciplined pricing practices in order to have appropriate evidence to separate elements of their arrangements and to allocate consideration to those elements (e.g., VSOE). VSOE is no longer required so an entity can evaluate whether it will change its pricing practices and its methods for determining estimated standalone selling prices.

  - Will the new guidance result in any changes to business practices (e.g., changes in contract terms or pricing policies that could affect estimates of standalone selling prices)?
  - Are there changes in contract terms that would affect revenue recognition under the new guidance (e.g., amending termination provisions to obtain appropriate payment for performance to date)?
  - Will planned changes have any effect on how an entity's sales force does business?

- **How will the guidance affect the entity's accounting policies?**

  Because many concepts in the new standard differ significantly from current GAAP, an entity will have to identify the updates necessary to existing policies to conform to the new revenue standard. In addition, with the increased level of judgments and estimates required by the new revenue standard, entities will likely need to establish clear policies to operationalize the new revenue accounting consistently across its operations. In addition, policies beyond those related to revenue may also be affected (e.g., policies related to other gains and losses, commissions, costs of fulfilling contracts).

- **What changes to internal controls are required?**

  In addition to data accumulation and IT changes, internal reporting processes and controls also will most likely require revision. A public entity subject to Section 404 of the Sarbanes-Oxley Act on internal control over financial reporting and Sections 302 and 906 on management certifications will be required to ensure that the design and operation of its internal controls remain effective when considering the new accounting guidance and disclose material changes to the internal controls during the period.

  - Will the entity be able to leverage existing processes and internal controls related to revenue with minor changes or will it use this opportunity to fundamentally rethink and optimize the control environment related to revenue?
  - What additional processes and controls will be necessary for the transition period (whether the additional controls are associated with the recasting of 2015 and 2016 or the required dual-bookkeeping for 2017 when using the modified retrospective method)?

- **What impact will the revenue recognition standard have on tax?**

  Changes in accounting for revenue for financial reporting purposes may have income tax implications. Under general tax principles, a company recognizes revenue when it has a fixed right to receive consideration and the amount can be determined with reasonable accuracy. Differences with revenue recognition under the new standard may arise in some cases, potentially leading to temporary differences. An entity should understand the impact of such book-tax revenue differences to assess the effects on deferred taxes and to assess whether existing methods of accounting for income tax purposes should be reviewed.

  - Will the standard lead to significant changes in temporary differences related to revenue?
  - Will the entity need to change tax accounting methods in light of the new financial accounting methods?
  - Will there be an impact on cash taxes? In some cases, revenue recognition for income tax purposes corresponds to the amounts recognized for financial accounting purposes, so changes to book revenue could change cash taxes.
  - How will the guidance affect transfer pricing?

10.4 Remaining implementation effort

The outputs of the assessment phase will determine the activities in the remaining phases of the implementation process. These activities will include developing new accounting policies and procedures; determining an approach to determine the cumulative effect upon transition, including tax effects; creating technical design documents for systems changes; and performing a variety of other activities across the accounting and reporting, tax, business processes and systems, change management, communication, and training workstreams.

10.5 Communicate with key stakeholders

Throughout the implementation effort, an entity should engage in frequent communication with key stakeholders (e.g., audit committees, investors, lenders, regulators), especially if it anticipates significant changes in the amount, timing and presentation of revenues.

10.5.1 Audit committee

Management should update the audit committee regularly on the new standard and the entity's implementation efforts, including:

- Overview of the new standard
- Anticipated effects on significant revenue streams
- Transition method

Audit committee members can be valuable resources for an entity during the implementation effort, given their experience and exposure to other companies facing the same challenges.

10.5.2 *Investors*

A public entity will be required to disclose information about the anticipated effects of the new standard until it is adopted. See Section 1.2.3 for a further discussion of this topic.

While a nonpublic entity is not required to make the disclosures described in SAB Topic 11.M, it may want to consider doing so to help inform financial statement users about potential changes in revenue recognition.

Endnotes:

[1] Technical Line: *A closer look at the new definition of a public business entity*
[2] ASC 250, *Accounting Changes and Error Corrections*
[3] ASC 985-605, *Software — Revenue Recognition*
[4] Item 301 of Regulation S-K
[5] SAB Topic 11.M, Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period
[6] ASC 840, *Leases*
[7] ASC 944, *Financial Instruments — Insurance*
[8] This exclusion includes contracts within the scope of the following Topics: ASC 310, *Receivables*; ASC 320, *Investments — Debt and Equity Securities*; ASC 323, *Investments — Equity Method and Joint Ventures*; ASC 325, *Investments — Other*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.
[9] ASC 460, *Guarantees*
[10] ASC 845, *Nonmonetary Transactions*
[11] Statement of Financial Accounting Concepts No. 6, *Elements of financial statements*
[12] ASC 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*
[13] ASC 330, *Inventory*
[14] Refer to ASC 605-20, *Revenue Recognition — Services*, specifically paragraph 605-20-S99-1.
[15] This statement applies only to transactions that are in the scope of the new guidance. Nonmonetary exchanges between entities in the same line of business that are arranged to facilitate sales to third parties (i.e., the entities involved in the exchange are not the end consumer) are excluded from the scope of the new guidance.
[16] ASC 820, *Fair Value Measurement*
[17] ASC 320, *Investments — Debt and Equity Securities*
[18] ASC 606-10-32-28
[19] ASC 606-10-32-33
[20] ASC 815, *Derivatives and Hedging*
[21] ASC 470-40, *Debt — Product Financing Arrangements*
[22] ASC 440-10-25, *Commitments — Unconditional Purchase Obligations*
[23] ASC 320-10, *Receivables — Nonrefundable Fees and Other Costs*
[24] ASC 330, *Inventory*
[25] ASC 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*
[26] ASC 270, *Interim Reporting*

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Appendix A: Disclosure checklist — Public entities

	Yes	No	N/A	Reference/explanation
The standard defines a public entity as one of the following: ▸ A public business entity (PBE) ▸ A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market ▸ An employee benefit plan that files or furnishes financial statements with the SEC Accounting Standards Update (ASU) 2013-12, *Definition of a Public Business Entity*, states that a business entity is a public business entity if it meets any of the following criteria: ▸ "(a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). ▸ (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. ▸ (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. ▸ (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. ▸ (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion." An entity that does not meet any of the above is considered a nonpublic entity for purposes of this standard.				
Contracts with customers				
1. An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other disclosure requirements: (ASC 606-10-50-4)				
a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue				
b. Any impairment losses recognized (in accordance with ASC 310 on receivables) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses on other contracts				

	Yes	No	N/A	Reference/explanation
Disaggregation of revenue				
2. An entity shall disclose the following related to disaggregated revenue:				
a. An entity shall disclose disaggregated 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. An entity shall apply the guidance in ASC 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue. (ASC 606-10-50-5)				
b. An entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with ASC 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies ASC 280 on segment reporting. (ASC 606-10-50-6)				
Contract balances				
3. An entity shall disclose all of the following: (ASC 606-10-50-8)				
a. The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed				
b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period				
c. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous reporting periods (for example, changes in transaction price)				
4. An entity shall explain how the timing of satisfaction of its performance obligations (see ASC 606-10-50-12(a)) relates to the typical timing of payment (see ASC 606-10-50-12(b)) and the effect that those factors have on the contract asset and contract liability balances. The explanation provided may use qualitative information. (ASC 606-10-50-9)				
5. An entity shall provide an explanation of the significant changes in the contract asset and contract liability balances during the reporting period. The explanation should include qualitative and quantitative information. Examples of significant changes include any of the following: (ASC 606-10-50-10)				
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, the estimate of the transaction price (including any constrained amounts) or a contract modification				
c. Impairment of a contract asset				
d. A change in the timeframe for a right to consideration to become unconditional (i.e., a contract asset reclassified to a receivable)				
e. A change in the timeframe for a performance obligation to be satisfied (i.e., the recognition of revenue arising from a contract liability)				

	Yes	No	N/A	Reference/explanation
Performance obligations				
6. An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following: (ASC 606-10-15-12)				
a. When the entity typically satisfies its performance obligations (e.g., upon shipment, upon delivery, as a bill and hold arrangement, as services are rendered, upon completion of service)				
b. The significant payment terms (e.g., when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, whether such estimate is constrained in accordance with ASC 606-10-32-11 through 32-13)				
c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e., if the entity is acting as an agent)				
d. Obligations for returns, refunds and other similar obligations				
e. Types of warranties and related obligations				
7. An entity shall disclose the aggregate amount of the transaction price allocated to remaining performance obligations as of the end of the current reporting period. (ASC 606-10-50-13(a))				
8. An entity shall explain when the entity expects to recognize the amount disclosed in accordance with ASC 606-10-50-13(a) either on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or by using qualitative information. (ASC 606-10-50-13(b))				
9. As a practical expedient, an entity need not disclose the information in ASC 606-10-50-13(a) and 50-13(b) for a performance obligation if either of the following conditions are met: (ASC 606-10-50-14)				
a. The performance obligation is part of a contract that has an original expected duration of less than one year				
b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with ASC 606-10-55-18				
10. An entity shall explain qualitatively whether it is applying the practical expedient in ASC 606-10-50-14 and whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with ASC 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see ASC 606-10-32-11 through 32-13). (ASC 606-10-50-15)				
Significant judgments in the application of the guidance in ASC 606				
11. An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in ASC 606 that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following: (ASC 606-10-50-17)				

	Yes	No	N/A	Reference/explanation
a. The timing of satisfaction of performance obligations (see ASC 606-10-50-18 through 50-19)				
b. The transaction price and the amounts allocated to performance obligations (see ASC 606-10-50-20)				
12. For performance obligations that an entity satisfies over time, an entity shall disclose both of the following: (ASC 606-10-15-18)				
a. The methods used to recognize revenue (e.g., a description of the output methods or input methods used and how these methods are applied)				
b. An explanation of why the methods used are a faithful depiction of the transfer of goods or services				
13. For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when the customer obtains control of promised goods or services. (ASC 606-10-15-19)				
14. An entity shall disclose information about the methods, inputs and assumptions used for all of the following: (ASC 606-10-15-20)				
a. Determine the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring noncash consideration				
b. Assessing whether an estimate of variable consideration is constrained				
c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)				
d. Measuring obligations for returns, refunds and other similar obligations				
Costs to obtain or fulfill a contract				
15. An entity shall describe both of the following: (ASC 340-40-50-2)				
a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with ASC 340-40-25-1 or 340-40-25-5)				
b. The method it uses to determine the amortization for each reporting period				
16. An entity shall disclose all of the following: (ASC 340-40-50-3)				
a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with ASC 340-40-25-1 or 340-40-25-5) by main category of asset (for example, costs to obtain contracts with customers, pre-contract costs, setup costs)				
b. The amount of amortization and any impairment losses recognized in the reporting period				
Practical expedients				
17. If an entity elects to use either the practical expedient in ASC 606-10-32-18 (about the existence of a significant financing component) or ASC 340-40-25-4 (about the incremental costs of obtaining a contract), the entity shall disclose that fact. (ASC 606-10-50-22)				

Appendix B: Disclosure checklist — Nonpublic entities

	Yes	No	N/A	Reference/explanation
The standard defines a public entity as one of the following: ▸ A public business entity (PBE) ▸ A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market ▸ An employee benefit plan that files or furnishes financial statements with the SEC Accounting Standards Update (ASU) 2013-12, *Definition of a Public Business Entity*, states that a business entity is a public business entity if it meets any of the following criteria: ▸ "(a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). ▸ (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. ▸ (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. ▸ (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. ▸ (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion." An entity that does not meet any of the above is considered a nonpublic entity for purposes of this standard.				
Contracts with customers				
1. An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other disclosure requirements: (ASC 606-10-50-4)				
a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue				
b. Any impairment losses recognized (in accordance with ASC 310 on receivables) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses on other contracts				

	Yes	No	N/A	Reference/explanation
Disaggregation of revenue				
2. An entity shall disclose, at a minimum, the following related to disaggregated revenue: (ASC 660-10-50-7)				
a. Revenue disaggregated according to the timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time)				
b. Qualitative information about how economic factors (e.g., type of customer, geographical information of customers, types of contract) affect the nature, amount, timing and uncertainty of revenue and cash flows				
Contract balances				
3. An entity shall disclose, at a minimum, the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed. (ASC 606-10-50-11)				
Performance obligations				
4. An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following: (ASC 606-10-15-12)				
a. When the entity typically satisfies its performance obligations (e.g., upon shipment, upon delivery, as a bill and hold arrangement, as services are rendered, upon completion of service)				
b. The significant payment terms (e.g., when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, whether such estimate is constrained in accordance with ASC 606-10-32-11 through 32-13)				
c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e., if the entity is acting as an agent)				
d. Obligations for returns, refunds and other similar obligations				
e. Types of warranties and related obligations				
Significant judgments in the application of the guidance in ASC 606				
5. An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in ASC 606 that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an nonpublic entity shall, at a minimum, disclose the following: (ASC 606-10-50-17)				
a. For performance obligations that an entity satisfies over time, an entity shall disclose the methods used to recognize revenue (e.g., a description of the output methods or input methods used and how these methods are applied) (ASC 606-10-15-18a)				
b. An entity shall disclose information about the methods, inputs and assumptions used for assessing whether an estimate of variable consideration is constrained (ASC 606-10-15-20(b))				

Appendix C: Illustrative examples included in standard

Example 1	Collectibility of the Consideration	Section 3.4
Example 2	Consideration Is Not the Stated Price — Implicit Price Concession	Section 3.1.5
Example 3	Implicit Price Concession	Not included
Example 4	Reassessing the Criteria for Identifying a Contract	Not included
Example 5	Modification of a Contract for Goods	Section 3.3.2
Example 6	Change in the Transaction Price after a Contract Modification	Not included
Example 7	Modification of a Services Contract	Not included
Example 8	Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue	Section 3.3.2
Example 9	Unapproved Change in Scope and Price	Section 3.3
Example 10	Goods and Services Are Not Distinct	Not included
Example 11	Determining Whether Goods or Services Are Distinct	Section 4.2.1
Example 12	Explicit and Implicit Promises in a Contract	Section 4.1
Example 13	Customer Simultaneously Receives and Consumes the Benefits	Section 7.1.1
Example 14	Assessing Alternative Use and Right to Payment	Section 7.1.3
Example 15	Asset Has No Alternative Use to the Entity	Not included
Example 16	Enforceable Right to Payment for Performance Completed to Date	Not included
Example 17	Assessing Whether a Performance Obligation Is Satisfied at a Point in Time or Over Time	Section 7.2
Example 18	Measuring Progress When Making Goods or Services Available	Not included
Example 19	Uninstalled Materials	Section 7.1.5
Example 20	Penalty Gives Rise to Variable Consideration	Not included
Example 21	Estimating Variable Consideration	Not included
Example 22	Right of Return	Section 5.2.2
Example 23	Price Concessions	Not included
Example 24	Volume Discount Incentive	Not included
Example 25	Management Fees Subject to the Constraint	Section 5.1.3
Example 26	Significant Financing Component and Right of Return	Section 5.3
Example 27	Withheld Payments on a Long-Term Contract	Not included
Example 28	Determining the Discount Rate	Section 5.3
Example 29	Advance Payment and Assessment of the Discount Rate	Not included
Example 30	Advance Payment	Not included
Example 31	Entitlement to Noncash Consideration	Section 5.4
Example 32	Consideration Payable to a Customer	Section 5.5
Example 33	Allocation Methodology	Section 6.1.4
Example 34	Allocating a Discount	Section 6.4
Example 35	Allocation of Variable Consideration	Section 6.3
Example 36	Incremental Costs of Obtaining a Contract (refers to ASC 340 example 1)	Section 8.3.1
Example 37	Costs That Give Rise to an Asset (refers to ASC 340 example 2)	Section 8.3.2
Example 38	Contract Liability and Receivable	Not included
Example 39	Contract Asset Recognized for the Entity's Performance	Not included
Example 40	Receivable Recognized for Entity's Performance	Not included
Example 41	Disaggregation of Revenue — Quantitative Disclosure	Section 9.3.1
Example 42	Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations	Section 9.3.1

Example 43	Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations — Qualitative Disclosure	Section 9.3.1
Example 44	Warranties	Not included
Example 45	Arranging for the Provision of Goods or Services (Entity is an Agent)	Not included
Example 46	Promise to Provide Goods or Services (Entity is a Principal)	Not included
Example 47	Promise to Provide Goods or Services (Entity is a Principal)	Section 4.4
Example 48	Arranging for the Provision of Goods or Services (Entity is an Agent)	Section 4.4
Example 49	Option that Provides the Customer with a Material Right (Discount Voucher)	Section 4.6
Example 50	Option that does not Provide the Customer with a Material Right (Additional Goods or Services)	Not included
Example 51	Option that Provides the Customer with a Material Right (Renewal Option)	Not included
Example 52	Customer Loyalty Program	Section 7.8
Example 53	Nonrefundable Upfront Fee	Not included
Example 54	Right to Use Intellectual Property	Not included
Example 55	License of Intellectual Property	Not included
Example 56	Identifying a Distinct License	Section 8.4.1
Example 57	Franchise Rights	Section 8.4.4
Example 58	Access to Intellectual Property	Section 8.4.3
Example 59	Right to Use Intellectual Property	Section 8.4.3
Example 60	Access to Intellectual Property	Not included
Example 61	Access to Intellectual Property	Not included
Example 62	Repurchase Agreements	Sections 7.3.1 & 7.3.2
Example 63	Bill-and-Hold Arrangement	Section 7.4